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IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1970

No. 1078

EDWIN J. HERWICH, on Behalf of All the Stockholders of National American Life Insurance Company,
Petitioner,

vs.

ROBERT E. WILDER and NATIONAL AMERICAN LIFE INSURANCE COMPANY, a Louisiana Corporation,
Respondents.

PETITION FOR A WRIT OF CERTIORARI
to the United States Court of Appeals for the Fifth Circuit

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IN THE

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OCTOBER TERM, 1970

No.

EDWIN J. HERPICH, on Behalf of All the Stockholders of National American Life Insurance Company,
Petitioner,

vs.

ROBERT E. WILDER and NATIONAL AMERICAN LIFE INSURANCE COMPANY, a Louisiana Corporation,
Respondents.

PETITION FOR A WRIT OF CERTIORARI
to the United States Court of Appeals for the Fifth Circuit

Petitioner prays that a Writ of Certiorari issue to review the Judgment of the United States Court of Appeals for the Fifth Circuit, entered in the above case on the 14th day of July, 1970.

OPINIONS BELOW

Neither the two District Court opinions below of Judge Frank Johnson, Jr. of the Middle District of Alabama of October 24, 1968 (p. A-3, *infra*), and January 14, 1969 (p. A-7, *infra*), nor the three opinions of July 14, 1970 of the Court of Appeals for the Fifth Circuit in this and two companion appeals (pages A-16, A-19 and A-64,

infra),[1] have been officially reported. Two District Court orders entered by Judge H. H. Grooms of the Northern District of Alabama in related litigation have not been officially reported and are reproduced *infra* at pages A 80 and A 82,[2] because of their relevance to this appeal.

JURISDICTION

The judgment below of the Court of Appeals for the Fifth Circuit was entered on July 14, 1970. On October 8, 1970, Mr. Justice Black extended the time for filing a Petition for Writ of Certiorari hereto to and including December 11, 1970. The jurisdiction of this Court is invoked under 28 U. S. C. 1254(1).

QUESTIONS PRESENTED

1. Does a corporation have a federal right of action, which may be asserted for its benefit in a derivative action brought by one of its stockholders, to recover from its former president a "premium" of more than one million dollars above market value allegedly paid the former president for his shares of stock (in the corporation and in its parent) where it is claimed that the former president engaged in a fraudulent scheme and in acts, practices and business dealings which operated as an equitable fraud upon the corporation in connection with the former president's sale of securities in violation of clauses (1)

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[1] Unofficially reported as **Herpich v. Wilder**, CCH Fed. Sec. L. Rep., ¶ 92,715 (5th Cir. July 14, 1970); **Herpich v. Wallace**, CCH Fed. Sec. L. Rep., ¶ 92,714 (5th Cir. July 14, 1970); and **Shell v. Hensley**, CCH Fed. Sec. L. Rep., ¶ 92,713 (5th Cir. July 14, 1970).

[2] Unofficially reported as **Hensley v. Shell**, CCH Fed. Sec. L. Rep., ¶ 92,289 (N. D. Ala. October 15, 1968); and **Hensley v. Love**, CCH Fed. Sec. L. Rep., ¶ 92,370 (N. D. Ala. March 12, 1969).

and (3) of SEC Rule 10b-5[3] and Section 10(b) of the Securities Act of 1934, 15 U. S. C., § 78j(b), in that the former president was approached by someone who desired to acquire control of the corporation and its assets, the former president could have cast the proposed transaction as a merger or as a sale of the corporation's assets or as a tender offer to all stockholders (on a *pro rata* basis or otherwise), but that the former president, in violation of his duty to the corporation, instead cast the transaction as one for his own personal benefit, sold his own shares of stock at a "premium" more than one million dollars above their market value, and failed to account to the corporation for the premium?

2. Do the minority stockholders of a corporation have a direct (as distinguished from derivative) federal right of action for damages against the former president of the corporation where it is claimed that the former president engaged in a fraudulent scheme and in acts, practices and business dealings which operated as an equitable fraud upon the minority stockholders in connection with the former president's sale of securities in violation of clauses (1) and (3) of SEC Rule 10b-5 and Section 10(b) of the Securities Act of 1934, 15 U. S. C., § 78j(b), in that the former president was approached by someone who desired to acquire control of the corporation and its assets, the former president could have cast the proposed transaction as a merger or as a sale of the corporation's assets

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[3] Rule 10b-5 provides, in part:

"It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, . . .

"(1) To employ any device, scheme, or artifice to defraud, . . .

"(3) To engage in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security."

or as a tender offer to all stockholders (on a *pro rata* basis or otherwise), but that the former president, in violation of his duty to minority stockholders, instead cast the proposed transaction as one for his own personal benefit, sold his own shares of stock at a "premium" more than one million dollars in excess of their market value, failed to insist that all the stockholders be made same offer, and failed to account for the premium?

STATUTES AND REGULATIONS INVOLVED

Relevant portions of Sections 10(b) and 27 of the Securities Exchange Act of 1934 (15 U. S. C., §§ 78j(b) and 78v) and SEC Rule 10b-5 (17 C. F. R., § 240.10b-5) are reproduced *infra* at pages A 1-2.

STATEMENT OF THE CASE

This petition seeks review of the order and judgment of the Court of Appeals in a civil action brought by a stockholder, seeking damages for the use and benefit of his corporation and also damages in his own right and for the use and benefit of other minority stockholders similarly situated.

The plaintiff's complaint in the District Court alleged that the defendant, Robert E. Wilder, formerly President, Chairman of the Board and Chief Executive Officer of National American Life Insurance Company (herein "National American"), engaged in a fraudulent scheme and in acts, practices and courses of business which operated as a fraud upon National American in connection with a sale by Wilder of securities. The complaint alleges that Wilder was approached by a group interested in acquiring control of National American and its assets, that Wilder could have cast the transaction as a merger of National American with another corporation or as a sale

of National American's assets or as a tender offer to all stockholders (on a *pro rata* basis or otherwise), but instead, in violation of his fiduciary duty, cast the transaction as a sale of his personally owned stock in National American and in First Colonial Corporation of America (which in turn owned a substantial block of stock of National American) at a premium more than one million dollars in excess of the then market value of Wilder's stock. The complaint alleges that Wilder agreed to resign and assist in electing nominees of the purchaser to office in National American, so as to enable the purchaser to obtain control of its assets. The complaint alleges that Wilder and the purchaser agreed that National American would be caused to pay part of the "premium" to Wilder. Plaintiff asserts that Wilder thereby engaged in a fraudulent scheme, acts, practices and courses of business dealings which operated as an equitable fraud upon National American and upon its minority stockholders, in that Wilder, in violation of his fiduciary duty, and by the use of the mails and means of interstate commerce, and in connection with the sale of his stock, converted to his own benefit an opportunity available to the corporation and all its stockholders.

In the two District Court opinions below, Judge Johnson stated that the Complaint and Amended Complaint sufficiently alleged a "fraud" and a sale of securities by Wilder but ruled that a federal cause of action under Rule 10b-5 was not stated because he said the required "connection" between the fraud and sale was not alleged and because the plaintiff and National American were not privy to the sale of securities by Wilder. Accordingly, the District Court dismissed the complaint for lack of jurisdiction, diversity jurisdiction being absent.

In its opinion below, the Court of Appeals affirmed so much of the District Court judgment as dismissed the individual and class claims, but reversed so much of the

District Court judgment as dismissed the derivative claims asserted under Rule 10b-5 for the use and benefit of National American for such of its damages as might be proved to have been sustained directly and as a proximate consequence of the alleged fraudulent scheme to cause National American to pay part of the excessive purchase price to Wilder by the contrivance and device of a subsequent merger of National American with an affiliate and successor in interest to the purchaser of Wilder's stock, the merger being considered a statutory "purchase" or "sale" of securities. See **SEC v. National Securities, Inc.**, 393 U. S. 453 (1969). The opinion of the Court of Appeals is somewhat unclear. That opinion states that Rule 10b-5 prohibits frauds only upon the "purchaser" or "seller" of securities and suggests that National American's claim for the premium, as distinguished from its claims for other damages allegedly sustained by it in connection with the merger scheme (1) arises solely from state law or (2) is cognizable under Rule 10b-5 only if shown to have been an integral part of a scheme to merge National American.

REASONS FOR GRANTING THE WRIT

It is respectfully submitted that this Court should grant certiorari in order to review and revise the decision of the Court of Appeals below. The decision below involves pervasive and extremely important questions with regard to the scope of duties imposed by the Securities Exchange Act of 1934 and Rule 10b-5 upon corporate officers, directors, and controlling stockholders with regard to their corporation and its stockholders. The decision below erroneously limits protections afforded investors and the public by federal law and regulations, and is in conflict with decisions of other circuits. These important questions and the conflicts between the circuits should be resolved by this Court.

I. The Decision Below Is of Great Importance and Improperly Limits Protection Afforded Investors and the Public by Rule 10b-5 and Section 10(b) of the Securities Exchange Act of 1934, 15 U. S. C., § 78j(b).

The scope of the duty owed to a corporation and to minority stockholders by the officers, directors and controlling stockholders of the corporation is a troublesome problem which has been the subject of a great deal of litigation and legal commentary. It is an extremely important question, affecting as it does not only the rights, duties and conduct of corporate fiduciaries but also insofar as it greatly affects the rights of the minority stockholders and the value of stock held by minority stockholders. Inasmuch as our American economy is largely based upon the willingness of public investors to invest in stock, it is extremely important that the standards of conduct imposed by federal securities laws and regulations be clarified and that the confusion, legal fog and uncertainties which have arisen in a number of lower court decisions, including the decision below and an early decision of the Second Circuit in **Birnbaum v. Newport Steel Corp.**, 193 F. 2d 461 (2d Cir.), **cert. denied**, 343 U. S. 956 (1952) be finally dispelled by this Court.

In a recent opinion, this Court commented upon the "complications" and "standing" problems which have vexed the lower court, citing an article by Lowenfels, entitled "The Demise of the Birnbaum Doctrine: A New Era for Rule 10b-5," 54 **Virginia Law Review**, 268 (1968), in footnote 9 of its opinion in **SEC v. National Securities, Inc.**, 393 U. S. 453 (1969).

We respectfully submit that this Court should grant certiorari in order to resolve once and for all whether Rule 10b-5 prohibits fraud "upon any person" in connection with the purchase or sale of securities, as the Rule ex-

pressly provides, rather than being limited to frauds committed upon "purchasers" or upon "sellers" of securities.

The opinion of the Court of Appeals for the Fifth Circuit, in a landmark decision in **Shell v. Hensley**, *infra* at p. A-64, and the recent *en banc* decision of the Court of Appeals for the Second Circuit in **Schoenbaum v. Firstbrook**, 405 F. 2d 215 (2d Cir. 1968), **cert. denied**, 395 U. S. 906 (1969) appear to recognize that "equitable fraud" as defined by this Court in **Moore v. Crawford**, 130 U. S. 122 at 128 (1889) is prohibited by Rule 10b-5. See, Comment, "**Schoenbaum v. Firstbrook**: The 'New Fraud' Expands Federal Corporation Law," 55 **Virginia Law Review** 1403 (1969), Patrick, "Rule 10b-5, Equitable Fraud and **Schoenbaum v. Firstbrook**, Another Step in the Continuing Development of Federal Corporation Law," 21 Alabama Law Review 457 (1969). In doing so, the two Courts of Appeal have merely applied to the Securities Exchange Act of 1934 the holding of this Court with regard to a similar provision in the Investment Advisers Act of 1940, 15 U. S. C. § 80b-1 et seq. in **SEC v. Capital Gains Research Bureau, Inc.**, 374 U. S. 180 at 193, 195 (1963):

> "Fraud has a broader meaning in equity [than at law] and intention to defraud or to misrepresent is not a necessary element.
>
> . . . .
>
> "Congress intended the Investment Advisers Act of 1940 to be construed like other securities legislation 'enacted for the purpose of avoiding frauds,' not technically and restrictively but flexibly to effectuate its remedial purposes.
>
> "Thus, even if we were to agree with the courts below that Congress had intended, in effect, to codify the common law fraud in the Investment Advisers Act of 1940, it would be logical to conclude that Congress codified the common law 'remedially' as the

courts had adapted it to the prevention of fraudulent securities transactions by fiduciaries, not 'technically' as it had traditionally been applied in damage suits between parties to arms length transactions involving land and ordinary chattels."

Having recognized that a fraud is sufficiently alleged, the District Court and Court of Appeals below held, nonetheless, that a federal cause of action under Rule 10b-5 could not be asserted unless the plaintiff was either a "purchaser" or "seller" or privy to the purchaser or seller in a securities transaction. We respectfully submit that Section 10(b) itself, which authorizes the Commission to adopt regulations for the protection of the public interest and for the protection of investors, and the language of Rule 10b-5 itself, which prohibits fraud "upon any person" in connection with a purchase or sale of securities militate against such a narrow construction of the statute and rule.

Applying the "purchaser-seller" doctrine, the court below held that petitioner and similarly situated shareholders did not have a direct (as distinguished from a derivative) right of action under Rule 10b-5 to recover the "premium" which Wilder fraudulently appropriated to himself by denying to minority shareholders equal opportunity to participate in the sale of control of their corporation.

This Court has recognized that a violation of the Securities Exchange Act of 1934 may give a shareholder both a derivative and a direct cause of action. In **J. I. Case Co. v. Borak**, 377 U. S. 426 (1964), this Court stated:

> "While the respondent contends that his Count II claim is not a derivative one, we need not embrace that view, for we believe that a right of action exists as to both derivative and direct causes."

This Court's conclusion in the **Bennett** case affirmed that of the Court of Appeals for the Seventh Circuit, at 317 F. 2d 920 (1963), in the same matter where that court stated:

> "We think the trial court failed to recognize the presumption that the same allegations of fact might support either a derivative suit or an individual cause of action by shareholders. We think Count I of the complaint adequately states a cause of action for the violation of rights individual to the [non-]stockholders."

In a recent case of control over minority under state law, **Jones v. H. F. Ahmanson & Co.**, 1 Cal. 3d 93, 81 Cal. Rptr. 592, 460 P. 2d 464 (1969), the court recognized the direct, individual right of the minority shareholders to assert a cause of action for the fraud perpetrated upon them by the controlling stockholders. The Supreme Court of California held in that case that minority stockholders had a right of action for the diminished market value of their stock resulting from "self-dealing" transfer of their own stock to a holding company, where the result was that there was a market in the holding company stock but no market in the stock of the savings and loan association. The Supreme Court of California stated:

> "Majority shareholders, either singularly or acting in concert to accomplish a joint purpose, have a fiduciary responsibility to the minority and to the corporation to use their ability to control the corporation in a fair, just, and equitable manner. Majority shareholders may not use their power to control corporate activities to benefit themselves alone or in a manner detrimental to the minority. Any use to which they put the corporation or their power to control the corporation must benefit all shareholders proportionately." 460 P. 2d 464 at 471.

The fact that the individual stockholders have not sold their stock in the corporation should not prevent them from asserting their claim when they have been defrauded in connection with a sale of securities. See **Blackwell v. Reynolds & Co.**, 267 F. Supp. 215, 18 Is N. Y. 1965), and **Oppor v. Hancock Securities Corp.**, 367 F. 2d 157 (2d Cir. 1966), where the defendant's fraud prevented the plaintiff from selling his stock advantageously.

The holding by the court below that petitioner and similarly situated shareholders cannot recover under Rule 10b-5 for a fraud upon them in connection with a purchase or sale of securities because petitioner and similarly situated stockholders are not "purchasers" or "sellers" imposes a mechanical rule of thumb as to standing which has no basis in Rule 10b-5 itself. Plaintiffs submit that the imposition of such a mechanical test is out of keeping with the purposes of Section 10(b) of the Securities Exchange Act of 1934, and Rule 10b-5, both of which were developed to provide flexible protection to investors. The "purchaser-seller" requirement has drawn critical fire in a number of law review articles, see, e.g., Lowenfels, "The Demise of the Birnbaum Doctrine: A New Era for Rule 10b-5," 54 **Virginia Law Review** 958 (1968); Schwartz, "The Rule of Control and the 1934 Act: New Directions for Federal Corporation Law," 3 **New York Law Forum** 674 (1957); Comment, "The Purchaser-Seller Rule: An Archaic Tool for Determining Standing Under Rule 10b-5," 56 **Georgetown Law Journal** 1177 (1968); Comment, "The Purchaser-Seller Limitation to SEC Rule 10b-5," 53 **Cornell Law Quarterly** 684 (1968); Payne, Recent Case Note: **Kahan v. Rosenstiel**, 1 **Cumberland Samford Law Review** 375 (1970).

In a number of briefs the Securities Exchange Commission has expressed the view that the "purchaser" or "seller" requirement imposed by **Birnbaum** was errone-

ous. See, e. g., Brief for SEC as Amicus Curiae at 5-9, **A. T. Brod v. Perlow**, 375 F. 2d 393 (2d Cir. 1967); Brief for SEC as Amicus Curiae at 5-6, **Vine v. Beneficial Finance Co.**, 374 F. 2d 627 (2d Cir. 1967); Brief for SEC as Amicus Curiae at 8, **Pacific Ins. Co. v. Blot**, 267 F. Supp. 956 (S. D. N. Y. 1967).

Petitioner respectfully submits that the appropriate occasion has arrived for this Court to rule that the purchaser-seller requirement of **Birnbaum** is no longer good law.

Even if the "purchaser seller" requirement of **Birnbaum** is not finally and totally discarded, the court below misconstrued Rule 10b-5 in not holding that under the doctrine of "equitable fraud" petitioner has standing, both individually and derivatively, to recover the premium received by Wilder.

Petitioner's Complaint alleges that Wilder conspired and agreed with the purchasers of control that he would "convert" to his own benefit a corporate opportunity to engage in a securities transaction, and that he would not account. Wilder chose to cast the transaction in a manner which would benefit him, rather than casting it in a manner which would benefit the corporation and all its stockholders, e. g., through a merger, tender offer (pro rata or other wise) or sale of assets. As this Court held in **Southern Pac. Co. v. Bogert**, 250 U. S. 482 (1919):

> "The wrong consists in the failure to share with them, the minority, the proceeds of the common property . . . and equity enforces the right by declaring the trust on which Southern Pacific holds it and ordering distribution or compensation."

In the analogous situation at common law, a person who converts someone else's property and sells it is "deemed"

to have acted as agent for the owner. The owner may sue "in assumpsit" and the wrongdoer is estopped to deny that the wrongdoer acted as agent for the owner in selling the converted property. See, e. g., **Martin v. Rutledge**, 94 Vt. 258, 110 Atl. 883 (1922); **Capital Garage Co. v. Powell**, 90 Vt. 277, 118 Atl. 222 (1920). As a fiduciary, Wilder was acting for his *cestuis que trust*—the corporation and its minority stockholders—so that Petitioner and the corporation should be deemed "sellers," with the right to require Wilder to account. As the Court of Appeals for the Second Circuit said in **A. T. Brod v. Perlow**, 375 F. 2d 393 (2d Cir. 1967):

> "We believe that § 10(b) and Rule 10b-5 prohibit all fraudulent schemes in connection with the purchase or sale of securities, whether the artifices employed involve a garden type variety of fraud, or present a unique form of deception. Novel or atypical methods should not provide immunity from the securities laws." 373 F. 2d at 396-97.

The Securities Exchange Act of 1934 manifests throughout a concern for the question of corporate control. Petitioner respectfully believes this Court should take jurisdiction of this cause to consider the important question raised as to the duty of a controlling stockholder with respect to his corporation and to minority stockholders in the transfer of corporate control.

II. The Decision Creates Unnecessary Ambiguities in an Important Area of the Law and Appears to Be in Conflict With Decisions of Other Circuits.

The decision below of the Court of Appeals finds that National American Life Insurance Company is a "purchaser" or "seller" within the statutory meaning of those terms with respect to a resolution of the Board of Di-

rectors of National American Life Insurance Company concerning the merger of National American Life Insurance Company with a company affiliated with the purchaser of Wilder's stock, National Securities, Inc., and its successor in interest with respect to the stock purchased from Wilder. This Court has held in **SEC v. National Securities, Inc.**, 393 U. S. 453 (1969) that a merger is a "purchase" or "sale" within the meaning of Securities Exchange Act of 1934. In accordance with its finding that National American Life Insurance Company was a "purchaser" or "seller", the Court below reversed and remanded, holding that plaintiffs had stated a Rule 10b-5 action for damages derivatively on behalf of National American:

> "... provided, of course, that the corporations can show that it was directly and proximately injured by the defendants' fraud or deceit in connection with the resolution to merge."

The Court below further stated:

> "On remand, therefore, it must be determined whether National American, as 'purchaser' or 'seller' has been proximately injured by acts amounting to the employment by defendants of a scheme to defraud the corporation in violation of the rule."

The decision below is ambiguous as to whether plaintiffs must show, in order to prove their claim under Rule 10b-5, that the corporation was damaged as a result of the resolution to merge. If the decision were so construed, it would be in conflict with **Errion v. Connell**, 236 F. 2d 447 (9th Cir. 1956), **Crane v. Westinghouse Air Brake Co.**, 419 F. 2d 787 (2d Cir. 1970), and **Vine v. Beneficial Finance Co.**, 374 F. 2d 627 (2d Cir. 1967). These cases have held that a plaintiff need not show that he has been injured by his purchase or sale of securities, so

long as he can show that he suffered damages in the overall scheme.

The Court of Appeals for the Ninth Circuit has held that there need not be a fraudulent representation concerning securities, so long as there is fraud "in connection with a purchase or sale of securities," in **Errion v. Connell**, 236 F. 2d 447 (9th Cir. 1956). There an eighty year old widow was induced to sell securities and to use the cash proceeds and other securities to purchase worth less tidelands represented to be oyster beds worth $1,200 per acre. In describing the representations made, the Court of Appeals said:

> "... the most important of which was the alleged fact that the Port of Coos Bay, Oregon, was planning to condemn the Oregon lands and would do so within a year, and that the land was reasonably worth $1,200 per acre; but that in order to establish such a valuation, Mr. Errion was inducing several people to buy the land there so that there would be sales within the area which would support such a valuation."
>
> • • • • • • •
>
> "We are of the opinion that the Act of 1934 was designed to cut out 'sharp practices' and fraudulent schemes **involving securities**, and the fact that there may be a co-mingling of securities with non-securities in the scheme does not oust the United States District Court of jurisdiction." [Emphasis supplied.]

In **Errion** the Court did not require the plaintiff to prove she had been deceived concerning the value of the securities sold for cash. It required only that she show damages in a fraudulent scheme "**involving securities**."

Vine v. Beneficial Finance Co., 374 F. 2d 627 (2d Cir. 1967) involved the allegedly fraudulent sale of controlling stock, which the Court of Appeals found to violate Rule

10b-5 based on facts striking analogous to those presented in the present action. Plaintiff in that case alleged that the Class "B" stockholders of Crown Finance Co., Inc., ("Crown") conspired with a prospective purchaser, Beneficial Finance Co., to "shape the transaction in such a way" that Class "B" stockholders would be paid about $700,000 for their shares plus about $200,000 in benefits under employment and consulting agreements. The alleged fraudulent scheme involved three steps: (1) a purchase by Beneficial of the Class "B" stock from the directors of Crown, (2) a public offer or tender by Beneficial to the holders of Class "A" stock to acquire 95% of the total outstanding shares of Crown, and (3) a short form merger of Crown into a subsidiary of Beneficial, which resulted in the forcing out of the remaining Class "A" shareholders, their assent being unnecessary. Plaintiff alleged that there was deceit and a failure to disclose material facts to the Class "A" stockholders in connection with the tender offer. Defendants argued that Plaintiff who had **not** tendered his stock, could not complain of any deceit practiced on other Class "A" stockholders. The Court of Appeals held that Plaintiff has standing to complain of the deception practiced on other Class "A" stockholders, since this deception was part of a scheme which allegedly damaged Plaintiff, and that he need not be a "seller" of his stock, because his rights were frozen and he could be required to "sell" his stock by the device of a short form merger.

The Court further held that the plaintiff did not have to show that he was damaged by the offer of an unfair price of $3.29 per share to him in the short-form merger, when he claimed that he and all class "A" stockholders had been injured by the fraudulent sale by class "B" stockholders, of control of the corporation to Beneficial Finance Co., at a premium.

In the very recent case of **Crane v. Westinghouse Air Brake Co.**, 419 F. 2d 787 (2d Cir. 1970), the Court held that the plaintiff, a defeated tender offeror who subsequently was forced to dispose, for anti trust reasons, of securities purchased preparatory to the tender offer, was a "seller" under Rule 10b-5 because of the subsequent sale of such securities. The plaintiff's tender offer had failed because a trade competitor, who subsequently merged with the target corporation, had manipulated the price of the stock on the last day of plaintiff's tender offer. The plaintiff complained of the trade competitor's purchases of stock from the public, transactions in which the plaintiff had not been a party, either as purchaser or seller. The "sale" which the Court of Appeals, following its earlier decision in **Vine v. Beneficial Finance Co.**, 374 F. 2d 627 (2d Cir. 1967), held gave plaintiff standing to complain of the stock manipulations of its trade competitor was its later sale of securities purchased preparatory to its take over bid. Plaintiff was fortunate enough to dispose of such securities at a profit of several million dollars. Plaintiff could scarcely have been said to have been injured **qua** seller or **qua** purchaser of securities. Its injury, caused by the market manipulations of its trade competitor, was the failure of its tender offer. Yet the Court found that the plaintiff had standing under Rule 10b-5 to complain of that injury.

Petitioner believes that, under the foregoing decisions in **Errion v. Connell**, *supra*, **Vine v. Beneficial Finance Co.**, *supra*, and **Crane v. Westinghouse Air Brake Co.**, *supra*, Petitioner should not be required, on trial of this cause, to show that National American Life Insurance Company had been directly and proximately injured by fraud directly involving the resolution to merge. The burden, both in trial and discovery, placed upon Petitioner by the added requirement imposed by the opinion below,

if read to require that the plaintiff must demonstrate injury caused by and directly related to the resolution to merge, denies to Petitioner the full protection intended by the promulgation of Rule 10b-5.

Even if the "purchaser-seller" rule is to be applied by federal courts in determining the scope of Rule 10b-5, the conflicts between circuits as to its application should be resolved by this Court so that investors, the financial community and the courts may have the benefit of a uniform rule.

III. This Court Should Grant Certiorari Herein and in Superintendent of Insurance as Liquidator for Manhattan Casualty Co. v. Bankers Life and Casualty Co., ... F. 2d ..., CCH Fed. Sec. L. Rep., ¶ 92,724 (2d Cir. July 22, 1970).

Petitioner is informed that a Petition for Certiorari will shortly be filed, or may have already been filed, in the case of **Superintendent of Insurance as Liquidator for Manhattan Casualty Co. v. Bankers Life and Casualty Co.**, ... F. 2d ..., CCH Fed. Sec. L. Rep., ¶ 92,724 (2d Cir. July 22, 1970). Superintendent of Insurance as Liquidator of Manhattan Casualty Company also involves a sale of control and raises important issues with respect to the concept of "equitable fraud," whether the fraud or deception complained of must relate to the securities purchased or sold, and the extent of the "purchaser-seller" requirement in an action under Rule 10b-5. Manhattan Casualty was a "seller" of securities in that it sold on the open market from its own portfolio, U. S. Government Bonds, apparently at a fair price, at the time of the closing of the sale of control. Manhattan Casualty was then fraudulently caused to make an unsecured "loan" of the proceeds realized from the sale of government bonds to the purchaser of control, thereby depleting its assets. The

purchaser of control failed to account to the corporation for its funds. The Court of Appeals for the Second Circuit held that there was no Federal Right of Action under Rule 10b-5, applying the "purchaser-seller" rule and holding that there was no "deception" of the corporation with respect to the sale of its U. S. Government Bonds, notwithstanding the plaintiffs' allegation that the application of the proceeds of the sale and plaintiffs' claim that the sale, loan, and failure to account were all pursuant to and an integral part of scheme to defraud.

The important issues raised in the **Superintendent of Insurance as Liquidator for Manhattan Casualty Co. v. Bankers Life and Casualty Co.** Petition for Certiorari are related to the issues presented in this petition. Petitioner respectfully submits that this Court should grant Writ of Certiorari in both cases.

CONCLUSION

For the reasons given hereinabove, this Court should issue its Writ of Certiorari to the Court of Appeals for the Fifth Circuit to review that Court's decision in this case.

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APPENDIX I

Pertinent Statutes and Regulations

§ 10(b), Securities Exchange Act of 1934, 15 U. S. C., § 78j:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange . . .
>
> * * * * * * *
>
> (b) The use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

§ 27, Securities Exchange Act of 1934, 15 U. S. C., § 78aa (in pertinent part):

> The district courts of the United States, and the United States courts of any Territory or other place subject to the jurisdiction of the United States shall have exclusive jurisdiction of violations of this chapter or the rules and regulations thereunder, and of all suits in equity and actions at law brought to enforce any liability or duty created by this chapter or the rules and regulations thereunder. Any criminal proceeding may be brought in the district wherein any act or transaction constituting the violation occurred. Any suit or action to enforce any liability or duty created by this chapter or rules and regulations

thereunder, or to enjoin any violation of such chapter or rules and regulations, may be brought in any such district or in the district wherein the defendant is found or is an inhabitant or transacts business, and process in such cases may be served in any other district of which the defendant is an inhabitant or wherever the defendant may be found.

Securities and Exchange Commission Rule 10b-5, promulgated pursuant to the Securities Exchange Act of 1934, 17 C. F. R., § 240.10b-5:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

APPENDIX II

In the United States District Court for the Middle District of Alabama, Northern Division

Edwin J. Herpich, on Behalf of All the Stockholders of National American Life Insurance Company, Plaintiff, vs. Robert E. Wilder; and National American Life Insurance Company, a Louisiana Corporation, Defendants.	Civil Action No. 2747-N.

Order

(Filed Oct. 24, 1968)

This cause is now submitted upon defendant Wilder's motion to dismiss. Three grounds for the motion are alleged: (1) failure to state a federal cause of action; (2) failure to make a demand of the directors and/or shareholders as required by Rule 23; and (3) failure to join the directors of the corporation as necessary parties.

Plaintiff's sole basis for federal jurisdiction is Section 27 of the Securities Exchange Act of 1934 (15 U. S. C., § 78aa). As there is no diversity, failure to state a federal cause of action deprives this Court of jurisdiction.

Plaintiff alleges numerous transactions by defendant Wilder which allegedly have damaged defendant corpo-

ration and/or the shareholders as a class. Numerous violations of Alabama law are alleged. The issue here is whether a violation of Rule 10b-5 has been adequately alleged. Simply stated, that issue is whether plaintiff has alleged fraud in connection with the purchase or sale of securities. This Court concludes that he has not.

Plaintiff seems to place principal reliance on the allegation that defendant Wilder sold a controlling block of shares in the corporation at a premium price without making the offer available, *i. e.*, disclosing it, to plaintiff. The difficulty with this allegation is that, while plaintiff has alleged a sale of securities and a fraud, he has not shown the required "connection." It is not alleged that plaintiff failed to disclose any relevant information to the buyer of his shares. Indeed, plaintiff suggests the buyer is most pleased. As to the corporation and the shareholders, defendant Wilder does not, on these facts, stand in the relationship of a seller. And, his status as a seller does not impose any duty upon him to disclose the transaction to these unrelated parties. Of course, Wilder may well have been under a duty to disclose the transaction to plaintiff, but if he was, that duty arose from his status as an insider and arises from state law. See, *e. g.*, **Perlman v. Feldmann**, 219 F. 2d 173 (2nd Cir. 1955). Although the broad statement in **Birnbaum v. Newport Steel Corp.**, 193 F. 2d 461 (2nd Cir. 1952), that a corporate mismanagement is not within the purview of Rule 10b-5 has been increasingly criticized, this Court is not aware that the narrow holding of the case has been questioned. **Birnbaum** holds that 10b-5 does not impose a duty to disclose to those who are not parties to the transaction.

Although it is not completely clear from the order, Judge Grooms' decision in **Hensley v. Shell**, Civil No. 63-641, N. D. Ala., Oct. 15, 1968, may be to the contrary. If it is, this Court respectfully disagrees. However, it

should be noted that Paragraph IV(1)(e) of the complaint in that case clearly alleges a 10b-5 action when it states that the defendant caused the corporation to purchase securities at an exorbitant price. **Hooper v. Mountain States Securities Corp.**, 282 F. 2d 195 (5th Cir. 1960); **Huckle v. Roto American Corp.**, 339 F. 2d 24 (2nd Cir. 1964). That allegation would certainly support denial of the motion to dismiss.

Plaintiff also relies on the allegation that defendant caused the corporation to guarantee the purchase of another corporation's purchase of certain bank stocks. Contrary to the suggestion in plaintiff's brief of October 22, it is not apparent from the complaint that the guaranty transaction is related to the above mentioned sale of control. In any event, the issue concerning the guaranty is whether it is tantamount to a purchase. At best it is a conditional purchase, since the corporation is only obligated to purchase if the primary purchaser defaults. This Court concludes that a conditional purchaser such as this does not have an action for damages under Rule 10b-5 absent an allegation that the condition has occurred. A conditional purchaser might be entitled to injunctive relief, see **Mutual Shares Corp. v. Genesco, Inc.**, 334 F. 2d 540, 546-47 (2nd Cir. 1967), but plaintiff here seeks only damages.

Because it is possible that out of this maze of wheeling and dealing a complaint might be drafted that states a federal cause of action, this one will be dismissed without prejudice to its being filed in substantially amended form and, of course, without prejudice to any actions plaintiff might bring in an appropriate state court. Concerning the possibility of amendment, however, it is only fair to note that this Court considers the present complaint an attempt to bring a large state law derivative action, absent diversity, into federal court on a poor 10b-5 theory. Even

if this Court had found a 10b-5 action in this case, the guides to the exercise of pendent jurisdiction set forth in **United Mine Workers of America v. Gibbs**, 383 U. S. 715, 722-27, virtually demand that the state law claims be dismissed.

Accordingly, it is the Order, Judgment and Decree of this Court that the motion of defendant Wilder to dismiss the complaint for failure to state a federal cause of action be and the same is hereby granted. It is further Ordered that the complaint in this action be and the same is hereby dismissed, without prejudice.

It is further Ordered that the costs incurred in this proceeding be and the same are hereby taxed against the plaintiff.

Done, this the 24th day of October, 1968.

Frank M. Johnson, Jr.
United States District Judge

APPENDIX III

In the United States District Court for the
Middle District of Alabama
Northern Division

Edwin J. Herpich, on Behalf of Himself and All Other Stockholders (Other Than Defendant Wilder and Persons in Conspiracy With Him) of National American Life Insurance Company, Plaintiff, vs. Robert E. Wilder; and National American Life Insurance Company, a Louisiana Corporation, Defendants.	Civil Action No. 2747-N

Order

(Filed Jan. 14, 1969)

This cause is now submitted on defendant Wilder's motion to dismiss plaintiff's amended complaint. Plaintiff seeks to recover for violations of Section 10(b) of the Securities Exchange Act of 1934, 15 U. S. C., Sec. 78j(b), of the Investment Company Act of 1940, 15 U. S. C., Secs. 80a-1, et seq., and of Alabama law. Plaintiff's original complaint was dismissed with leave to amend for failure to state a federal cause of action by an order of this Court filed October 24, 1968. Although the amended complaint adds the count under the Investment Company

Act and makes other changes in the original, it also fails to state a federal cause of action.

Plaintiff Herpich is a stockholder in National American Life Insurance Company and seeks to recover derivatively on behalf of that corporation and representatively on behalf of its stockholders. With respect to the count under the Investment Company Act, the amended complaint alleges that defendant Wilder was a "controlling person" of both National American and First Colonial Corporation. It is also alleged that Wilder caused First Colonial to fail to register as an investment company as required by the Act. Wilder also allegedly caused First Colonial to control National American and caused National American to make inadequately secured loans to First Colonial and to enter into purchases and sales of stock with First Colonial.

There is no longer much doubt that in a proper case a court will imply civil liability for violation of the Investment Company Act. See **Brown v. Bullock**, 294 F. 2d 415 (2nd Cir. 1961); **Esplin v. Hirschi**, 402 F. 2d 94 (10th Cir. 1968). See also **Greater Iowa Corp. v. McLendon**, 378 F. 2d 783 (8th Cir. 1967), which seriously questions the only authority to the contrary, **Brouk v. Managed Funds, Inc.**, 286 F. 2d 901 (6th Cir. 1961). This, however, is not such a case.

It is a corollary of the doctrine of implied liability in tort for violation of a criminal statute that the plaintiff must be within the class the statute was designed to protect. See, *e. g.*, Restatement (Second), Torts, Section 286. Here, it is not alleged that the plaintiff or National American are stockholders in the alleged investment company. The only injuries complained of are to a "controlled" corporation and only a derivative recovery in favor of National American is sought.

Plaintiff suggests that Wilder violated several provisions of the Investment Company Act. However, plaintiff is clearly not within the class that some of these provisions were designed to protect. Section 17 prohibits various transactions of certain affiliated persons and underwriters. Section 36, 15 U. S. C., Sec. 80a-37, authorizes the Commission to seek injunctions against gross misconduct and abuse of trust. Even if the complaint adequately alleged violations of these statutes, which it does not, it seems clear from the terms of the provisions that they were designed only for the protection of the shareholders of an investment company.

Assuming, arguendo, that First Colonial was required to register as an investment company, the complaint can be read as alleging a violation of Section 7(a) of the Act, which provides in pertinent part:

> "Section 80a-7. Transactions by unregistered investment companies.
>
> (a) No investment company organized or otherwise created under the laws of the United States or of a State and having a board of directors, unless registered under Section 80a-8 of this title, shall directly or indirectly
>
> * * * * * * *
>
> (5) control any company which is engaged in any business in interstate commerce."

It is adequately alleged that National American was controlled by First Colonial. Since Section 43, 15 U. S. C., Sec. 80a-47, prohibits procuring violations of the subchapter, it is also adequately alleged that defendant Wilder caused First Colonial to fail to register.

This Court cannot conclude, however, that Section 7 was designed to protect the class of which plaintiff's corporation is a member. In the only case in which a similar issue was squarely faced, **Greater Iowa Corp. v. Mc-**

Lendon, *supra*, the same conclusion was reached. There defendants were disenchanted shareholders of plaintiff corporation who formed a voting trust in an attempt to change the management. Plaintiff alleged that this trust constituted an investment company and attempted to force it to register. But Judge Gibson, speaking for the Eighth Circuit, stated:

> "A reading of the 'Findings and Declarations of Policy' at 15 U. S. C., Sec. 80a 1 indicates that the Act was primarily aimed at the protection of individuals who purchase the security issued by the investment company. Repeated reference is made to the security holder and to the investor, without mention of the class of which plaintiffs are members. The Act provides for disclosure of pertinent facts to the shareholders, fair management, investment of assets for the benefit of shareholders rather than management, sound financing of the company; all generally or specifically designed for the protection of the investing public.
>
> Plaintiffs have no legal connection with defendants' operation. They are not competitors being injured by illegal practices. They are not investors being deprived of the protection afforded by the Act. They are not privies or beneficiaries of any contract with defendants. Plaintiffs are merely fellow shareholders and the issuer of the securities held by this alleged investment company. We see no basis under this Act that the issuer company can oversee the trading of its securities or object to the method in which its shares are acquired or the persons who acquire them." **Greater Iowa Corp. v. McLendon**, *supra* at 793-94.

Plaintiff seeks to distinguish **Greater Iowa Corp.** on the ground that here the situation involves contractual rela-

tions between a controlled corporation and a violator of the statute. Plaintiff argues in effect that Section 7 in terms confers standing upon a controlled corporation when it prohibits control by an **unregistered** company. But since the Act contains no restrictions as such on control of companies by **registered** investment companies, it is difficult to conclude that it manifests an intent to protect controlled or dominated companies. To the contrary, it seems plain that the purpose of the disabilities set forth in Section 7 is to propel investment companies into registering and thus to subject them to the regulation contemplated by the Act.

The other substantial contention plaintiff asserts involves the claim that defendant Wilder violated Section 10(b) of the 1934 Act in connection with his sale of a controlling bloc of shares in National American. The previous dismissal order rejected the bald claim that the sale of a controlling bloc of shares without sharing the profits or disclosing the offer to the other stockholders violates federal law. That holding was based on the failure to allege any "connection" between the alleged fraud and the sale of securities as required by Rule 10b-5. **Birnbaum v. Newport Steel Corp.**, 193 F. 2d 461 (2nd Cir. 1952) was cited for the narrow holding that there is no duty of disclosure to those not rather directly interested in the purchase or sale as a puchase or sale. For purposes of clarity, this Court would repeat that it did not rely upon the broad proposition found in **Birnbaum** that Section 10(b) was not aimed at fraudulent mismanagement of corporate affairs. Clearly, acts can constitute both fraudulent mismanagement and violations of Section 10(b), although those acts originally alleged did not. Nor was **Birnbaum** relied upon for the requirement that one must be an actual purchaser or seller in order to have standing to invoke the protections of the Act. Rather, this Court simply held that the phrase "in connection with the pur-

chase or sale of securities" limits the duties of disclosure imposed by the Act. The article attached to plaintiff's brief, Lowenfels, **The Demise of the Birnbaum Doctrine: A New Era for Rule 10b-5**, 54 Va. L. Rev. 268 (1963), is hardly inconsistent with that conclusion. This Court followed the recommendation that it:

> "come immediately to grips with the central problem of most Section 10(b) and Rule 10b-5 cases whether or not the plaintiff has in fact been defrauded **in connection with the purchase or sale of a security.**" *Id.* at 277 (Emphasis added.)

In oral argument on the amended complaint plaintiff has indicated that his theory is not based solely on a failure of disclosure, but rather relies also on the third section of Rule 10b-5, which provides:

> "It shall be unlawful for any person, directly or indirectly, by use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,
>
> * * * * * * *
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security."

Apparently plaintiff urges that the phrase "in connection with the purchase or sale of securities" be treated as merely a jurisdictional event, much like the use of the mails, and that sale of control at a premium, when a "fairer" method such as a sale of assets is available, is a fraudulent course of business. Treating the "connection" language as jurisdictional rather than substantive would mean realistically that the dealings with their shareholders of the insiders of every corporation that issues "securities" within the meaning of the Act would be subject to

a full-blown federal common law of fraud. The federal courts have been liberal in developing a law of securities transactions, but the step urged by plaintiff, although arguably desirable, goes considerably beyond any of the cases cited by plaintiff, does not seem authorized by the language and structure of the statute, and is not one this court is willing to take. Even if it were, it is not clear that every sale of control at a premium should be held a fraud on stockholders.

In his amended complaint, plaintiff has added the allegation that defendant Wilder caused National American to pay part of the consideration he received for his sale of control. If supported by the other allegations of the complaint, this would establish the requisite "connection since the corporation would then be, *pro tanto*, a purchaser" of the securities. See **Hooper v. Mountain States Securities Corp.**, 282 F. 2d 195 (5th Cir. 1960); **Ruckle v. Roto American Corp.**, 339 F. 2d 24 (2nd Cir. 1964).

Although the exact details of the transactions by which Wilder is alleged to have received part of his consideration are not clear from the complaint, the essential facts have emerged. Wilder is alleged to have received *inter alia*, from National Securities, Inc., the purchaser of the control bloc, an option to purchase 43,200 shares of certain bank stock. This same bank stock earlier had been the subject of a purchase agreement in favor of First Colonial Corporation (controlled by Wilder, owner of a large bloc of National American stock, also sold to National Securities, and allegedly insolvent), which purchase was guaranteed by National American. It is not alleged how National Securities intended to acquire the asset of its subsidiary (either First Colonial or National American), but the complaint adequately alleges a relationship between the transactions by a conspiracy of the principals to accomplish an overriding purpose.

Viewing the complaint most favorably to plaintiff, it might seem that he has alleged a scheme whereby Wilder profits by exercising the option if the price of the stock increases and whereby National American is the loser if the price of the stock decreases. In any event, it could be said that the credit of National American was extended for the benefit of the defendant. It is not alleged, however, that National American has ever been called upon to fulfill its guarantee. As this Court's previous order made clear, one cannot usually collect damages conditional on an event that has yet to occur. Here, it might be argued that the extension of credit itself caused the damage; but for the guarantee, National American would have been in a position to make other profitable investments. The complaint does not, however, seek damages for this type of loss. Nor does it specifically request declaratory or injunctive relief with respect to the guaranty agreement. This Court concludes that the complaint does not state a cause of action based on this narrow theory of the guaranty agreement—option transaction.

It is manifest from a reading of the complaint as a whole that the purpose of the allegations concerning the guaranty agreement is to resurrect the sale of control theory. Presumably, the contention is that whatever fraud might be found in the guaranty agreement—option transaction somehow "tainted" the entire sale of control. Conceptually, however, the two theories are quite separate, and this Court can find no reason in policy why that distinction should be blurred.

Finally, it should be made clear that even if the complaint were read to state a cause of action based on the narrow theory arising out of the guaranty agreement—option transaction, this Court would not exercise its discretion in favor of exercising pendent jurisdiction over whatever state law claims plaintiff might have arising out of

the sale of control at a premium. Besides being logically and factually distinct, the two claims are of disproportionate size and importance. As the Supreme Court stated in **United Mine Workers v. Gibbs**, 383 U. S. 715, 727:

> "Once it appears that a state claim constitutes the real body of a case, to which the federal claim is only an appendage, the state claim may fairly be dismissed."

In accordance with the foregoing, it is the Order, Judgment and Decree of this Court that defendant Wilder's motion to dismiss be granted and the complaint is hereby dismissed.

The costs of this proceeding are Ordered to be and are hereby taxed against the plaintiff.

Done, this the 14th day of January, 1969.

Frank M. Johnson, Jr.
United States District Judge

APPENDIX IV

In the
United States Court of Appeals
For the Fifth Circuit

No. 27385

Edwin J. Herpich, on Behalf of Himself
and All Other Stockholders, Etc.
Plaintiffs-Appellants

versus

Robert E. Wilder, et al.
Defendants-Appellees

Appeal From the United States District Court for the
Middle District of Alabama

(July 14, 1970)

Before Ainsworth, Dyer and Simpson
Circuit Judges

Ainsworth, Circuit Judge: As in **Herpich v. Wallace,**[1] decided today, we must determine in this case whether minority shareholders of a Louisiana corporation have stated a claim for relief under various sections of the fed-

[1] 5 Cir., 1970, ... F. 2d ... [No. 27729, ...].

eral securities laws[2] so as to entitle them to challenge in federal court, this time in Alabama, the way in which control of their corporation was sold. **Herpich v. Wallace** was directed primarily against the purchasers of control, the so-called Arizona Group. This case is directed against the seller, Robert E. Wilder. The District Court dismissed plaintiffs' complaint against Wilder on the pleadings. With respect to claims under section 10(b) of the Securities Exchange Act of 1934, 15 U. S. C., § 78j(b), and, more particularly, SEC Rule 10b-5, 17 C. F. R., § 240.10b-5, we conclude that the District Court erred. Therefore, for reasons set forth in our opinion in the **Wallace** case, we hold that the judgment appealed from must be reversed in part.[3] The case is remanded for further proceedings not inconsistent with the opinion in **Wallace**, and plaintiffs shall be afforded an opportunity to amend their complaint against Wilder to reflect additional information they say they have obtained since the complaint, as amended, was filed herein.

The principal difference between this case and **Wallace** is that defendants in **Wallace** are the present management of National American Life Insurance Company,

[2] Securities Exchange Act of 1934, § 10(b), 15 U.S.C., § 78j (b), and SEC Rule 10b-5, 17 C. F. R., § 240.10b-5, thereunder; Securities Act of 1933, § 17(a), 15 U. S. C., § 77q(a); Investment Company Act of 1940, 15 U. S. C., § 80a-1 *et seq.*

[3] Count one in this case corresponds to the Investment Act claims aspect of count one in **Wallace**; dismissal of these claims is affirmed. Count two in this case corresponds roughly to the 1933 and 1934 Act claims aspect of count one in **Wallace**; on remand plaintiffs shall be afforded the opportunity to amend count two here to place this case on an even footing with **Wallace**. Count three in this case (the Harris transaction) corresponds to count two in **Wallace** in which a 10b-5 claim is stated. Count four here (the Latta transaction) corresponds to count three in **Wallace**, in which a 10b-5 claim is not stated. Count four in **Wallace** has no counterpart here because plaintiffs do not seek injunctive relief against Wilder individually.

but Wilder, to some extent, has departed the scene. The complaint against Wilder, however, alleges that he has committed overt acts in furtherance of the conspiracy between him and the Arizona Group defendants in **Wallace**. Consequently, having allegedly joined the conspiracy and taken steps to assure its success, Wilder may be held responsible for the acts of his coconspirators in furtherance of their scheme. **Dasho v. Susquehanna Corporation**, 7 Cir., 1967, 380 F. 2d 262, 267, n. 2; **accord, Shell v. Hensley**, 5 Cir., 1970, ... F. 2d ... [Nos. 27447 and 27514, ...].[4]

On remand, we leave to the determination of the District Court whether any nonfederal claims presented lie within that Court's pendent jurisdiction, and the wisdom of exercising such pendent jurisdiction as is found to exist. **See Kletschka v. Driver**, 2 Cir., 1969, 411 F. 2d 436, 450.

The judgment is Affirmed in part and Reversed in part, and the case is Remanded for further proceedings in accordance with this opinion.

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[4] We have carefully examined the various differences between this case and **Wallace** and have concluded that they are immaterial to the question whether this case must be sent back for the normal process of factual development and a determination of the merits of the case.

APPENDIX V

In the
United States Court of Appeals
for the Fifth Circuit

No. 27729

Edwin J. Herpich, et al.
Plaintiffs-Appellants

versus

Robert H. Wallace, Jack E. Love, et al.
Defendants-Appellees

Appeal from the United States District Court for the Eastern District of Louisiana

(July 14, 1970)

Before Ainsworth, Dyer and Simpson
Circuit Judges

Ainsworth, Circuit Judge: In this case we must determine whether minority shareholders of a Louisiana corporation have stated a claim for relief under various sections of the federal securities laws which entitles them to challenge in federal court, absent diversity, the way in which control of their corporation was sold to an Arizona-based complex of insurance companies. The District Court dismissed their complaint on the pleadings, thus relegating them to the state courts. This appeal requires us to consider basic aspects of the implied right of action for violation of section 10(b) of the Securities Exchange

Act of 1934, 15 U. S. C., § 78j(b), and, more particularly, SEC Rule 10b-5, 17 C. F. R., § 240.10b-5, promulgated thereunder, which right was recognized by this Court in **Reed v. Riddle Airlines**, 5 Cir., 1959, 266 F. 2d 314. The principal issues with which we deal are (1) the standing of plaintiffs to bring this suit under Rule 10b-5 and (2) the extent to which the conduct about which plaintiffs complain is actionable under the rule. In addition, we are asked to recognize various implied rights of action under the Investment Company Act of 1940, 15 U. S. C., § 80a-1 *et seq.*

Plaintiffs are shareholders of National American Life Insurance Company, a Louisiana corporation. Plaintiffs brought this suit on behalf of themselves and similarly situated National American shareholders, and derivatively on behalf of National American. It is a companion to **Herpich v. Wilder**, 5 Cir., 1970, ... F. 2d ... [No. 27385, ...], also decided today by this Court. The principal defendants, referred to as the "Arizona Group," control the present management of National American. Some two or more years ago, the Arizona Group ventured South in search of acquisitions. Following their purchases of control of various insurance companies, among which was National American, they were met with numerous lawsuits challenging their means of acquiring these companies. This action is directed primarily against the purchasers of control of National American. **Herpich v. Wilder**, on the other hand, is directed against the seller of control.

The Arizona Group is comprised of National Securities, Inc. (NSI), Old National Life Insurance Company, Robert H. Wallace, and Jack E. Love, NSI, a Colorado corporation, has its headquarters in Arizona and carries on business through several wholly or partially owned subsidiary or affiliated corporations, including insurance companies. A majority of NSI's stock is owned

by Old National, an Alabama corporation. Old National is said by plaintiffs to be wholly owned by a voting trust of which Wallace and Love are equal beneficiaries. The non-Group defendants here are Luther D. Harris, a director and "controlling person" of National American since 1963, and Raymond A. Latta, who from time to time has served as a consulting actuary to National American.

Plaintiffs' four-count complaint, as amended, alleges violations of section 10(b) of the Exchange Act, Rule 10b-5, section 17(a) of the Securities Act of 1933, 15 U. S. C., § 77q(a), various sections of the Investment Company Act, and applicable state law. Plaintiffs seek damages and injunctive relief where appropriate for themselves and the class of National American share holders they seek to represent, and also on behalf of National American itself. Federal jurisdiction is predicated upon section 27 of the Exchange Act, 15 U. S. C., § 78aa, section 22 of the Securities Act, 15 U. S. C., § 77v, and section 44 of the Investment Company Act, 15 U. S. C., § 80a-43.[1] In the court below, defendants filed motions to dismiss for want of subject-matter jurisdiction and for failure to state a claim upon which relief can be granted. The District Judge granted these motions and plaintiffs appeal.

I

From the amended complaint, sworn affidavits, and attached documents,[2] the following allegedly occurred:

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[1] Plaintiffs also sought to invoke the pendent jurisdiction of the District Court, **see**, *e. g.*, United Mine Workers of America v. Gibbs, 383 U. S. 715, 86 S. Ct. 1130 (1966), and cited 28 U. S. C., § 1337.

[2] After the Court had heard oral argument in this and the related Arizona Group cases decided today, both sides filed supplemental memoranda with the Clerk. Sworn affidavits and attached copies of purported documents were also filed by plaintiffs, who allege that they obtained the information filed as a result of discovery in other Arizona Group cases proceeding in the federal and state courts.

Until January 24, 1968, Robert E. Wilder, who is not a defendant in this case,[3] was the majority shareholder of First Colonial Corporation of America. First Colonial is an "investment company" within the meaning of the Investment Company Act of 1940,[4] but has never complied with the registration and qualifications imposed upon such companies by that act. Wilder owned 55.39 per cent of First Colonial's outstanding common stock. This stock was worthless except for the value of First Colonial's controlling interest in National American. Wilder, as a result of his stockholdings in First Colonial (which owned 26.81 per cent of National American's outstanding common stock), and in National American itself (6.32 per cent of the outstanding common), was in working control of National American. He exercised his power of control over the two corporations as president, director, and chairman of the board of National American and as president and director of First Colonial. This power of control was for sale.

A. The Sale of Control

In late November 1967, Wilder allegedly conspired and agreed with the Arizona Group to defraud National American and the other National American shareholders and to cause National American to transact business with the unregistered investment company that controlled it. Wilder would transfer control of National American to the Arizona Group at a premium price payable to him in part by National American itself. This would be done by causing National American to acquire by indirection some of Wilder's shares of National American and First Colonial stock at a price in excess of the market value of these

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[3] Plaintiffs filed a complaint against Wilder in the Middle District of Alabama. Herpich v. Wilder, M. D. Ala., 1969, Civ. No. 2747-N, **rev'd**, 5 Cir., 1970, ... F. 2d ... [No. 27385, ...].

[4] Investment Company Act of 1940, § 3, 15 U. S. C., § 80a-3.

shares. This result was to be accomplished by means of the following device: NSI would be caused to purchase all of Wilder's shares of National American and First Colonial stock at a price, payable in NSI notes, at least $3,000,000 in excess of the then market value of these shares; the Arizona Group would then cause Alabama National Life Insurance Company, an Alabama corporation they controlled,[5] to replace the notes issued by NSI to Wilder with premium debentures of its own; finally, the Arizona Group would cause a merger into one company of Alabama National, National American, and another Arizona Group corporation. As a further inducement to Wilder, the Arizona Group would cause to be issued to him an option to purchase 54 per cent of the outstanding common stock of Capitol National Bank of Montgomery, Alabama. In return, Wilder would resign his positions at National American and facilitate the election of Wallace and Love and their associates to management positions there.

To carry out their plans, defendants, either as principals or as aiders and abettors, are alleged to have caused the following to be done: NSI and Wilder executed an agreement under which Wilder sold his First Colonial and National American stock to NSI for $5,000,000. This price was $3,000,000 in excess of the then market value of the stock. The Arizona Group paid this premium to acquire control of National American. Control was sought to enable the Arizona Group to loot the corporation and otherwise to waste the corporation's assets to the detriment of the corporation and its shareholders. The Group did not offer to purchase National American stock from plaintiffs or other members of plaintiffs' class on the same terms

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[5] The way in which the Arizona Group acquired Alabama National is being challenged by minority shareholders of that corporation in the Hensley group of cases. *E. g.*, Shell v. Hensley, 5 Cir., 1970, ... F. 2d ... (Nos. 27447 and 27514, Hensley v. Love, N. D. Ala., 1969, 298 F. Supp. 698

given Wilder. Defendants next caused National American and First Colonial to execute an agreement with Federated Investments, Inc. Under this agreement, First Colonial, then insolvent, was to purchase from Federated Investments 43,200 shares of Capitol National Bank of Montgomery stock for $1,188,000. Purchase of these shares, which constituted 54 per cent of the outstanding common stock of the bank, was guaranteed by National American. On or about January 24, 1968, defendants caused NSI to grant Wilder an option to purchase these same shares of bank stock. This option was given as partial payment of the price due Wilder for his First Colonial and National American stock. Because defendants cast the transfer of control of National American as a sale of stock from Wilder to NSI, Wilder realized a premium for passing control of National American's assets which was not made available to or enjoyed by the other shareholders of National American.

B. **The Harris Transaction**

The facts alleged by plaintiffs are as follows: When the Arizona Group acquired control of National American in January 1968, they caused the corporation to continue to honor its obligations under an agreement it made with Harris on February 24, 1967. Under this agreement, National American was to purchase 12,947 shares of First Colonial common stock from Harris, then a National American director, for the excessive price of $100,000. This stock was then worthless. Documents were drawn to indicate that the transaction was a loan by National American to Harris which was secured by a pledge of Harris' stock. The principal amount of the purported loan was to be paid to Harris at the rate of $2,500 a month. In the event Harris defaulted, National American agreed that it would not assert a deficiency against the director regardless of the value of the pledged stock at

the time of the default. The Arizona Group continues to cause the corporation to disburse $2,500 to Harris each month thereby causing the corporation to purchase worth less stock. It does not appear that Harris is in default on the purported loan.

C. The Latta Transaction

Plaintiffs' allegations show the following: On or about April 18, 1967, National American was caused by Latta to arrange the payment of $100,000 to Latta by the device of guaranteeing a "loan" by an unnamed person to Latta in that amount. This purported loan was made to finance Latta's purchase of 20 per cent of the outstanding stock of Dawl Corporation, a Louisiana corporation then owned in part by Wilder. The Dawl stock purchased by Latta was pledged as security for the so called loan. Subsequently, on or about July 1, 1967, Latta exchanged his Dawl stock for First Colonial stock. Although this First Colonial stock is not worth the amount Latta owes on the loan, National American was caused to agree to the substitution of this stock for the Dawl stock as security for the loan. In connection with the $100,000 transaction, National American was caused to agree to pay Latta $45,000 for no consideration whatever to the corporation. It is not alleged that Latta is in default on the loan of $100,000

D. Mismanagement of National American and the Proposed Merger

Since acquiring control of National American, it is alleged that the Arizona Group, aided and abetted by Latta and Harris, have wasted the assets of the corporation. They intend to engage in similar wasting in the future. Moreover, defendants propose to merge National American, Alabama National, and another corporation the Group controls into one company at terms disadvantageous to

National American and the shareholders of National American. Specifically, National American will be caused by the terms of the merger to acquire Wilder's First Colonial and National American stock at the excessive price NSI paid to Wilder for selling control of National American in the first place. To carry out this plan, defendants solicited proxies by mail in September 1968 to elect their nominees to the board of National American. These proxies are said to have been misleading in some manner not pleaded with particularity.

With respect to all wrongs alleged in the complaint, plaintiffs, one of whom was a director of National American, aver that they did not discover the facts they allege until February 14, 1968. Plaintiffs state that they could not have discovered these facts earlier by the exercise of any duty imposed upon them because defendants and those in conspiracy with defendants concealed and misrepresented the facts to prevent National American shareholders from discovering the fraud and deceit being practiced upon them.

All four counts of the amended complaint allege that defendants, either as principals or as aiders and abettors, have in various ways violated section 10(b) of the Securities Exchange Act of 1934 and, more particularly, Rule 10b-5, promulgated thereunder by the Securities and Exchange Commission (SEC).[6] Count one also alleges

[6] Violations of section 17(a) of the Securities Act of 1933, 15 U. S. C. § 77q(a), are also alleged. In this case, however, we need not reach the question whether an implied right of action should be recognized for violations of section 17(a), since section 10(b) of the Exchange Act and Rule 10b-5 thereunder will support as well as would section 17(a) an action for any monetary or injunctive relief to which plaintiffs or their corporation may be entitled. **See,** e. g., Globus v. Law Research Service Inc., 2 Cir., 1969, 418 F. 2d 1276, 1283. **See also** 3 and 6 Loss, Securities Regulation 1778-1791 (2d ed. 1961), 3907-3915 (Supp. to 2d ed. 1969). Consequently, we pretermit discussion of section 17(a) in this opinion.

violations of the Investment Company Act of 1940. The allegations of count one relate primarily to the sale of control by Wilder to the Arizona Group and the means by which this sale was and is being financed. Count two involves the Harris transaction, while count three involves the Latta transaction. Finally, count four, incorporating the allegations of count one by reference, relates primarily to the proposed merger of National American and other Arizona Group corporations into one company. Counts one, two, and three seek damages. Counts two and four seek injunctive relief. Use of the mails is alleged in all counts.

For reasons that follow, we conclude that plaintiffs have stated claims that are triable in the federal courts. Accordingly, without making any suggestion how this case should be determined on the merits, *e. g.*, **Orr v. Thorpe**, 5 Cir., 1970, ... F. 2d ... [No. 27674, June 10]; **Merlite Land, Sea & Sky, Inc. v. Palm Beach Investment Properties, Inc.**, 5 Cir., 1970, ... F. 2d ... [No. 28565, March 19]; **Exhibitors Poster Exchange, Inc. v. National Screen Service Corp.**, 5 Cir., 1970, 421 F. 2d 1313, we reverse in part the judgment of the District Court and remand the case for further proceedings not inconsistent with this opinion.

II

Defendants contend that the "ultimate wisdom" on this case is that the complaint represents an attempt to bring a large state-law derivative action, absent diversity, into federal court on a poor 10b-5 theory.[7] They argue that

[7] Defendants take their contention from a statement made by District Judge Frank M. Johnson, Jr., in the order dismissing plaintiffs' original complaint in the Wilder case [No. 27385]: ". . . [I]t is only fair to note that this Court considers the present complaint an attempt to bring a large state law derivative action, absent diversity, into federal court on a poor 10b-5 theory." Herpich v. Wilder, M. D. Ala., 1968, Civ. No. 2747-N.

plaintiffs lack standing to invoke the private right of action afforded by section 10(b) of the Exchange Act and Rule 10b-5 and that the conduct about which plaintiffs complain is not within the coverage of the section and the rule.

This Court has infrequently had occasion to consider 10b-5 theories, [see n. 4 infra.] Consequently, in determining the questions of standing and coverage presented in this case, we proceed on a relatively unmarked trail. We are, however, not without some guidance, directed as we are by decisions from this and other Circuits and by the "familiar canon of statutory construction that remedial legislation [such as the Exchange Act]" should be construed broadly to effectuate its purposes." **Tcherepnin v. Knight**, 389 U. S. 332, 336, 88 S. Ct. 548, 553 (1967); **Bunn v. Global Marine, Inc.**, 5 Cir., 1970, ... F. 2d ... [No. 28302, June 18].

Section 10 of the Exchange Act, entitled "Regulation of the Use of Manipulative and Deceptive Devices," reads in relevant part as follows:

> "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange
>
> ...

[4] Various aspects of the rule have been considered in the following cases: Rekant v. Desser, 5 Cir., 1970, ... F. 2d ... [No. 25872, April 20]; Kuehnert v. Texstar Corporation, 5 Cir., 1969, 412 F. 2d 700; Lehigh Valley Trust Co. v. Central Nat. Bank of Jacksonville, 5 Cir., 1969, 409 F. 2d 989; Grumbles v. Times Herald Printing Co., 5 Cir., 1968, 387 F. 2d 593; Azalea Meats, Inc. v. Muscat, 5 Cir., 1967, 386 F. 2d 5; Hooper v. Mountain States Securities Corporation, 5 Cir., 1960, 282 F. 2d 195; Reed v. Riddle Airlines, 5 Cir., 1959, 266 F. 2d 314.

[5] Tcherepnin v. Knight, 389 U. S. 332, 336, 88 S. Ct. 548, 553 (1967). **See also** Loomis, **The Securities Exchange Act of 1934 and the Investment Advisers Act of 1940**, 28 Geo. Wash. L. Rev. 214 (1960).

"(b) To use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."

By section 10(b) Congress meant to prevent manipulation and control of the prices at which securities are bought and sold and to enable buyers, sellers, and traders of securities to make a proper appraisal of the value of securities. Securities Exchange Act of 1934, § 2(3), 15 U. S. C., § 78b(3). **See also** Hearings on Stock Exchange Regulation Before the House Comm. on Interstate and Foreign Commerce, 73d Cong., 2d Sess. (1934); Ruder, **Civil Liability Under Rule 10b-5: Judicial Revision of Legislative Intent?**, 57 Nw. U. L. Rev. 627, 657 (1963)." Thus the section reflects the design of the Exchange Act as a means for preventing inequitable and unfair practices on securities exchanges and over-the-counter markets and for insuring fairness and honesty in securities transactions generally. 48 Stat. 881; **see SEC v. Texas Gulf Sulphur Co.**, 2 Cir., 1968, 401 F. 2d 833, 847-848 (en banc). A fundamental purpose of the Act was "to substitute a philosophy of full disclosure for the philosophy of *caveat emptor*." **SEC v. Capital Gains Research Bur.**, 375 U. S. 180, 186, 84 S. Ct. 275, 280 (1963); **see Tcherepnin v. Knight**, 389 U. S. 332, 336, 88 S. Ct. 548, 553 (1967); **Ansbacher-Siegle, Inc. v. Muscat**, 5 Cir., 1967, 386 F. 2d 5, 8. Congress sought to protect persons "who would be engaged in buying and selling and trading in . . . securities as broadly defined in the Act." **Hooper v. Mountain States Securities Corporation**, 5 Cir., 1960, 282 F. 2d 195, 202.

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[10] This is not to say, however, that section 10(b) is limited to manipulative or deceptive devices employed with respect to the investment value of securities. **See** Hooper v. Mountain States Securities Corp., 5 Cir., 1960, 282 F. 2d 195; A. T. Brod & Co. v. Perlow, 2 Cir., 1967, 375 F. 2d 393.

It did not make section 10(b) self-executing, nor did it limit the section's application to the manipulative and deceptive devices or contrivances known in 1934. Instead, it wrote the section as a "catch all" meant to reach practices employed in connection with the purchase or sale of securities which were contrary to the public interest or the interest of investors. See Hearings on Stock Exchange Regulation Before the House Comm. on Interstate and Foreign Commerce, 73d Cong., 2d Sess. 115 (1934)." To the SEC was granted rulemaking authority to define that which Congress made unlawful in section 10(b) namely, the use, in connection with the purchase or sale of securities, of "manipulative or deceptive devices or contrivances."

Rule 10b-5, entitled "Employment of Manipulative and Deceptive Devices," reads as follows:

> "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,
>
> "(1) to employ any device, scheme, or artifice to defraud,
>
> "(2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> "(3) to engage in any act, practice, or course of business which operates or would operate as a fraud

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11 "The Administration's spokesman needed only a single sentence to dispose of the somewhat broader version of [§ 10(b)] which was § 9 (c) of the original 1934 bills: 'Subsection (c) says, "Thou shalt not devise any other cunning devices."'" 3 Loss, Securities Regulation 1424 (2d ed. 1961). See also Ruder, Civil Liability Under Rule 10b-5: Judicial Revision of Legislative Intent?, 57 Nw. U. L. Rev. 627 (1963).

or device upon any person, in connection with the purchase or sale of any security."

The SEC adopted Rule 10b-5 in 1942 to close a "loophole in the protections against fraud administered by the Commission by prohibiting individuals or companies from buying securities if they engage in fraud in their purchase." SEC Sec. Exch. Act Rel. No. 3230 (May 21, 1942). The purpose of the rule, it seems clear, was to afford sellers of securities the same protections already afforded purchasers by the federal scheme of securities regulation. Previously, fraud on sellers, as distinct from fraud on purchasers, see Securities Act of 1933, § 17(a), 15 U. S. C., § 77q(a), was not covered by the securities acts unless committed by an over the counter broker or dealer. 8 SEC Ann. Rep. 10 (1943); see Securities Exchange Act of 1934, § 15(c), 15 U. S. C., § 78o(c). Viewing the rule as an "additional protection to investors," 8 SEC Ann. Rep. 10 (1943), the Commission fashioned it to "make applicable to the purchase of securities, the same broad antifraud provisions which the Congress has imposed in Section 17(a) of the Securities Act of 1933, in connection with the sale of securities." Ward La France Truck Corp., 13 S. E. C. 373, ... n. 8 (1943). To accomplish this end, the Commission simply copied the language of section 17(a) of the Securities Act, with exceptions unimportant in this context, and applied it "in connection with the purchase or sale of any security," this being the reach of section 10(b). See also Birnbaum v. Newport Steel Corp., 2 Cir., 1952, 193 F. 2d 461, 463; 3 and 6 Loss, Securities Regulation 1424-1427 (2d ed. 1961 & 3617 (Supp. 2d ed. 1969).

Together the section and the rule aim at reaching "misleading or deceptive activities, whether or not they are precisely and technically sufficient to sustain a common law action for fraud and deceit." Cady, Roberts & Co., 40 S. E. C. 907, ... (1961), carried on "in connection with" the purchase or sale of securities. They are not

intended as a specification of particular acts or practices that constitute "manipulative or deceptive devices or contrivances," but are instead designed to encompass the infinite variety of devices that are alien to the "climate of fair dealing." **SEC v. Capital Gains Research Bur.**, 375 U. S. 180, 201, 84 S. Ct. 275, 288 (1963), that Congress sought to create and maintain. **See A. T. Brod & Co. v. Perlow**, 2 Cir., 1967, 375 F. 2d 393, 397; **Cady, Roberts & Co.**, 40 S. E. C. 907 (1961). The operative terms of Rule 10b-5 "fraud," "deceit," "purchase," "sale," and "security," as well as the phrase "in connection with" are infused with special meanings. Their construction, the Supreme Court has admonished, must be broad and flexible so that the remedial purposes of the section and the rule will be effectuated. **Tcherepnin v. Knight**, 389 U. S. 332, 88 S. Ct. 548 (1967); **SEC v. Capital Gains Research Bur.**, 375 U. S. 180, 84 S. Ct. 275 (1963). In this area especially, therefore, a case-by-case approach is necessary to the proper development of controlling precedent.

Where, as in this and the other Arizona Group cases decided today, serious questions of public law are presented on pleadings alone, we proceed cautiously, lest we are pulled into academic exercises in a case that factually may never be. **Fred. v. Board of Public Instruction of Dade County, Fla.**, 5 Cir., 1969, 415 F. 2d 851. For purposes of this appeal, the well-pleaded allegations of plaintiffs' amended complaint must be taken as true. **Walker Process Equip. v. Food Mach. & Chem. Corp.**, 382 U. S. 172, 86 S. Ct. 347 (1965); **Cliff Food Stores, Inc. v. Kroger, Inc.**, 5 Cir., 1969, 417 F. 2d 203. Moreover, "[i]n appraising the sufficiency of the complaint we follow, of course, the accepted rule that a complaint should not be dismissed for failure to state a claim unless it appears beyond doubt that the plaintiff can prove no set of facts in support of his claim which would entitle him to relief." **Conley v. Gibson**, 355 U. S. 41, 45-46, 78 S. Ct. 99, 102 (1957). **See**

also Barber v. Motor Vessel "Blue Cat", 5 Cir., 1967, 372 F. 2d 926. We turn now to decide the questions of standing and coverage presented.

III

A. Count One

Plaintiffs contend that count one presents three interlocking but separate foundations for private actions under section 10(b) and Rule 10b-5. These foundations are as follows:

(1) National American and its shareholders other than defendants are said to have been defrauded "in connection with" Wilder's sale of securities to the Arizona Group. Because Wilder and the Group defendants cast the sale of control of National American in the form of a sale of Wilder's stock at a premium over market value, Wilder is said to have diverted a corporate opportunity to himself, aided and abetted by the other conspirators, in fraud of the corporation and its other shareholders.

(2) National American and its shareholders other than defendants are said to have been damaged as a result of acts done by defendants in furtherance of their scheme to cause National American indirectly to purchase Wilder's stock in First Colonial and National American. Specifically, it is claimed that defendants agreed as part of their conspiracy that Wilder would transfer control of National American to the Arizona Group for the purpose of enabling the Group to loot the corporation and otherwise to waste its assets. The inducement to Wilder was the premium of $3,000,000 ultimately to be paid by National American itself. As a party to the "plan" to merge National American and Alabama National into one company—thereby causing National American to purchase Wilder's stock at the premium price—National

American is said to be a "purchaser" defrauded "in connection with" its purchase of securities.

(3) As an integral part of the conspiracy between Wilder and the Group, National American was caused to guarantee a promise of First Colonial, then insolvent, to purchase 43,380 shares of Capitol National Bank stock from Federated Investments. Subsequently, NSI granted Wilder an option to purchase the same bank stock. The guarantee by National American is said to constitute a "purchase" "in connection with" which National American has been defrauded.

We consider these three purported bases for a Rule 10b-5 civil action insufficient support for plaintiffs' argument that they are persons entitled to sue on behalf of themselves and their class of National American shareholders for rule violations based upon the allegations of count one. This is not to say, however, that plaintiffs have not stated a 10b-5 claim for relief on behalf of their corporation. As we shall discuss, count one does support a claim for derivative relief on behalf of National American. But on their own behalf, plaintiffs do not claim that they or other members of their class purchased or sold securities in connection with defendants' alleged employment of manipulative or deceptive devices or contrivances; nor do they claim that their damage resulted from their participation in a securities transaction. Therefore, for reasons that follow, we conclude that they are not entitled to bring an action under Rule 10b-5 on behalf of themselves or their class, as distinct from a derivative action on behalf of National American, on the facts alleged in count one.

Private actions (as opposed to SEC actions) brought to enforce liabilities and duties created by the section and the rule have been recognized by this Court since 1959. **Reed v. Riddle Airlines**, 5 Cir., 1959, 266 F. 2d 314. The

private right of action implied under Rule 10b-5 may be invoked on behalf of a corporation in a shareholder's derivative suit. **Bennett v. Breuer**, 3 Cir., 1970, ... F. 2d ... (No. 25872, April 20); see, e. g., **City National Bank of Fort Smith v. Vandeburgh**, 8 Cir., 1970, 422 F. 2d 221; **Camden v. Richardson**, 7 Cir., 1969, 411 F. 2d 489; **Schoenbaum v. Firstbrook**, 2 Cir., 1968, 405 F. 2d 215 (en banc); cf. **Borochia v. Wilson Hotels Corporation**, 383 U. S. 363, 86 S. Ct. 845 (1966); **J. I. Case Company v. Borak**, 377 U. S. 426, 84 S. Ct. 1555 (1964). In **Hooper v. Mountain States Securities Corporation**, 5 Cir., 1960, 282 F. 2d 195, 201, we based our recognition of the private right on the principles set forth in the landmark case of **Kardon v. National Gypsum Co.**, E. D. Pa., 1946, 69 F. Supp. 512. Foremost among these principles is the common law tort doctrine that a person injured by violation of a statute enacted for the benefit of persons in his position may bring his own action seeking redress for the harm caused him. **Kardon v. National Gypsum Co.**, *supra* at 513; see Restatement of Torts, 286 (1938). **See also** Bromberg, Securities Law: Fraud—SEC Rule 10b-5, § 2.4(1)(a) (1967). Supporting this doctrine is the policy undergirding the Exchange Act of providing complete, effective enforcement of the duties and liabilities imposed by the Act. See, e. g., **Ellis v. Carter**, 9 Cir., 1961, 291 F. 2d 270, 274. The SEC deems itself unequipped to make persons whole who have been injured by violations of Rule 10b-5; it seeks only to deter violators of the rule by making violations unprofitable. Brief for the SEC as Amicus Curiae, in **Dolgow v. Anderson**, E. D. N. Y., 1968, 43 F. R. D. 472, 483. Moreover, the Commission has neither the manpower nor the time that completely effective enforcement of the securities laws by it alone would require. Consequently, private actions brought for violations of the rule serve as a "necessary supplement to Commission action." **J. I. Case Company v. Borak**, 377 U. S. 426, 432, 84 S. Ct. 1555,

1380 (1964). As in other contexts, the possibility of monetary damages or injunctive relief in a private action can be a most effective weapon in the enforcement of the antifraud provisions, section 10(b) and Rule 10b-5.

The volume of private litigation under section 10(b) and Rule 10b-5 has increased spectacularly in recent years. With this increase have come an "extraordinary expansion of subject matter coverage" by the section and the rule and the possibility of "extraordinarily great liability" for their violation. **Bisbano v. Donner**, 5 Cir., 1970, ... F. 2d ... [No. 29872, April 20]; **see Mutual Shares Corporation v. Genesco, Inc.**, 2 Cir., 1967, 384 F. 2d 540, 543 n. 6. As the substantive law of Rule 10b-5 develops, a continuing problem confronting the courts concerns the nature of the protection created by the rule, that is, how far should that protection be extended.

In recognizing a private right of action and its corollary, implied civil liability, for violations of Rule 10b-5, courts have a duty to provide such remedies as are necessary to make effective the congressional purpose behind the section and the rule. **J. I. Case Company v. Borak**, 377 U. S. 426, 433, 84 S. Ct. 1555, 1560 (1964); **Sola Electric Co. v. Jefferson Electric Co.**, 317 U. S. 173, 176, 63 S. Ct. 172, 174 (1942). The broad remedial purposes of the Exchange Act suggest that the relief made available should not be limited to a particular type of remedy. **J. I. Case Company v. Borak**, *supra*; **Mutual Shares Corporation v. Genesco, Inc.**, 2 Cir., 1967, 384 F. 2d 540, 547. In the formulation of relief, however, concepts of fairness to those who are expected to govern their conduct under Rule 10b-5 should be considered. Protection for investors is of primary importance, but it must be kept in mind that the nation's welfare depends upon the maintenance of a viable, vigorous business community. Considered alone, the sweeping language of Rule 10b-5 creates an almost completely undefined liability. All that

the rule requires for its violation is that someone "do something bad," Jennings & Marsh, Securities Regulation 961 (2d ed. 1968), in connection with a purchase or sale of securities. Without further delineation, civil liability is formless, and the area of proscribed activity could become so great that the beneficial aspects of the rule would not warrant the prescription. **See Ruder, Pitfalls in the Development of a Federal Law of Corporations by Implication Through Rule 10b-5**, 59 Nw. U. L. Rev. 185, 207-208 (1964). In recognition of this problem, courts have sought to construct workable limits to liability under section 10(b) and Rule 10b-5 which will accommodate the interests of investors, the business community, and the public generally.[12] At the very bold, the problem has been to determine the class of persons who are entitled to bring a private action under the section and the rule. To that problem we now turn.

The standing of a private plaintiff to sue for violations of section 10b-5 and Rule 10b-5 is to be decided, of course, within the framework of Article III of the United States Constitution, which restricts federal judicial power to "cases" and "controversies." **Association of Data**

[12] "Thus, a requirement of privity was at first suggested, see Joseph v. Farnsworth Radio & Television Corp., 99 F. Supp. 701 (S. D. N. Y. 1951), aff'd per curiam, 198 F. 2d 883 (2d Cir. 1952), but has more recently been ignored, e. g., Cochran v. Channing Corp., 211 F. Supp. 239, 243-245 (S. D. N. Y. 1962); see Texas Continental Life Ins. Co. v. Dunne, 307 F. 2d 242 (6th Cir. 1962); Cooper v. North Jersey Trust Co., 226 F. Supp. 972, 978 (S. D. N. Y. 1964)." Mutual Shares Corporation v. Genesco, Inc., 2 Cir., 1967, 384 F. 2d 540, 543, 544 (footnotes omitted). Other limitations have included requirements (1) that the plaintiff actually has relied upon the allegedly fraudulent statement, List v. Fashion Park, Inc., 2 Cir., 1965, 340 F. 2d 457, 462-463, (2) that reliance was reasonable, Rogen v. Ilikon Corporation, 1 Cir., 1966, 361 F. 2d 260, 266-267, (3) that the fraud was the cause in fact of the plaintiff's harm, Barnett v. Anaconda Company, S. D. N. Y., 1965, 239 F. Supp. 766, 776, and (4) that the plaintiff's harm was foreseeable, Vine v. Beneficial Finance Co., 2 Cir., 1967, 374 F. 2d 627, 635.

Processing Service Org., Inc. v. Camp, 397 U. S. 150, 151, 90 S. Ct. 827, 829 (1970). The law of standing has been concerned almost entirely with public law questions such as determinations of constitutionality and review of administrative or other governmental action. Every plaintiff in the federal courts, however, must satisfy the court that he is a proper party to maintain the action he brings — that he has a personal stake in the outcome of the controversy. **See Flast v. Cohen**, 392 U. S. 83, 101, 88 S. Ct. 1942, 1953 (1966); **Baker v. Carr**, 369 U. S. 186, 204, 82 S. Ct. 691, 703 (1962). "The various rules of standing applied by federal courts have not been developed in the abstract. Rather, they have been fashioned with specific reference to the status asserted by the party whose standing is challenged and to the type of question he wishes to have adjudicated." **Flast v. Cohen**, 392 U. S. 83, 101, 88 S. Ct. 1942, 1953 (1968). In the context of a plaintiff seeking to invoke a remedy afforded by section 10(b) of the Exchange Act and Rule 10b-5, "[t]he first question is whether the plaintiff alleges that the challenged [conduct] has caused him injury in fact, economic or otherwise." **Association of Data Processing Service Org., Inc. v. Camp**, 397 U. S. 150, 152, 90 S. Ct. 827, 829 (1970). The second question is whether "the interest sought to be protected by the complainant is arguably within the zone of interests to be protected" by section 10(b) and Rule 10b-5 thereunder, 397 U. S. at 153, 90 S. Ct. at 830. **See also Barlow v. Collins**, 397 U. S. 159, 90 S. Ct. 832 (1970).

When Congress vested federal district courts with exclusive jurisdiction of "all suits in equity and actions at law brought to enforce any liability or duty created by [the Exchange Act] or the rules and regulations thereunder," Securities Exchange Act of 1934, § 27, 15 U. S. C., § 78aa, it must necessarily have assumed that this jurisdiction would be invoked only by those showing injury to the type that the Act seeks to prevent. **Cf. SEC v.**

General Time Corp., 2 Cir., 1968, 407 F. 2d 65, 71. Section 10(b) and Rule 10b-5 do not proscribe all fraudulent schemes concocted to take undue advantage of investors, but only those fraudulent schemes that are employed "in connection with the purchase or sale of any security." Congress, when it used the quoted language, did not intend necessarily to require a purchase or sale of securities by the alleged violator as a precondition to the establishment of a violation of the section and the rule, but meant instead to outlaw the employment of manipulative or deceptive devices or contrivances, however novel or atypical they might be, "of a sort that would cause reasonable investors to rely thereon, and, in connection therewith, so relying, cause them to purchase or sell . . . securities." **SEC v. Texas Gulf Sulphur Co.**, 2 Cir., 1968, 401 F. 2d 833, 860 (en banc). The objectives of section 10(b) are purity of the securities transaction and the securities trading process. Congress was concerned with preventing injury to buyers and sellers of securities, and the basic interest sought to be protected was that of persons engaged in "buying and selling and trading in . . . securities as broadly defined in the Act," **Hooper v. Mountain States Securities Corporation**, 5 Cir., 1960, 282 F. 2d 195, 202, to transact in securities in a "climate of fair dealing." **SEC v. Capital Gains Research Bur.**, 375 U. S. 180, 201, 84 S. Ct. 275, 288 (1963); **see Birnbaum v. Newport Steel Corp.**, 2 Cir., 1952, 193 F. 2d 461, 464. In short, Congress meant to afford investors a reasonable opportunity to make knowing, intelligent decisions regarding their purchases and sales of securities in unmanipulated markets, **see Kahan v. Rosenstiel**, 3 Cir., 1970, 424 F. 2d 161, 173, and the loss resulting in connection with purchases or sales without benefit of such an opportunity is the type of injury section 10(b) and Rule 10b-5 seek to prevent. **See Mutual Shares Corporation v. Genesco, Inc.**, 2 Cir., 1967, 384 F. 2d 540, 546. **See also Britt v. Cyril Bath Company**, 6 Cir., 1969, 417 F. 2d 433, 435.

We are of the opinion that only purchasers and sellers of securities involved in an alleged Rule 10b-5 violation that is, securities in connection with which fraud has allegedly been committed can show injury of the type the rule is meant to prevent. The rule was promulgated for their benefit, **see Greater Iowa Corporation v. McLendon**, 8 Cir., 1967, 378 F. 2d 783, and it is they who may invoke the 10b-5 right of action to obtain recompense for economic loss sustained. **See, e. g., Vanderboom v. Sexton**, 8 Cir., 1970, 422 F. 2d 1233; **City National Bank of Fort Smith v. Vanderboom**, 8 Cir., 1970, 422 F. 2d 221; **Iroquois Industries, Inc. v. Syracuse China Corporation**, 2 Cir., 1969, 417 F. 2d 963; **Greenstein v. Paul**, 2 Cir., 1968, 400 F. 2d 580. Those seeking to bring an action for damages sustained as a result of a violation of the rule must show a wrong done to them, that is, an invasion of their own federally protected interest to engage in securities transactions while free from the effects of deceptive or unfair practices employed in connection therewith, not merely a wrong done to someone else. **See Association of Data Processing Service Org., Inc. v. Camp**, 397 U. S. 150, 90 S. Ct. 827 (1970). We conclude, therefore, that for a plaintiff to establish his standing to maintain a Rule 10b-5 action for damages, he must be a purchaser or seller of the securities involved in connection with the alleged rule violation.

We do not say that only those who are purchasers or sellers in the "strict common law traditional sense," **Hooper v. Mountain States Securities Corporation**, 5 Cir., 1960, 282 F. 2d 195, 203, may maintain an action for damages under Rule 10b-5. **See, e. g., Mader v. Armel**, 6 Cir., 1968, 402 F. 2d 158; **Dasho v. Susquehanna Corporation**, 7 Cir., 1967, 380 F. 2d 262. In deciding whether a plaintiff has standing, we search for what will best accomplish the congressional purpose. **See, Electronic Specialty Co. v. International Controls Corp.**, 2

Cir., 1969, 409 F. 2d 937, 946. Thus we construe the "in connection with the purchase or sale of any security" clause found in both the section and the rule broadly and flexibly to effectuate that purpose. **Tcherepnin v. Knight**, 389 U. S. 332, 88 S. Ct. 548 (1967); **SEC v. Capital Gains Research Bur.**, 375 U. S. 180, 84 S. Ct. 275 (1963). The "purchaser" "seller" standing requirement is to be similarly construed, see, *e. g.*, **Mader v. Armel**, 6 Cir., 1968, 402 F. 2d 158; **Vine v. Beneficial Finance Company**, 2 Cir., 1967, 374 F. 2d 627, so that the broad design of the section and the rule is not frustrated by the use of novel or atypical transactions. **Crane Company v. Westinghouse Air Brake Company**, 2 Cir., 1969, 419 F. 2d 737; **A. T. Brod & Co. v. Perlow**, 2 Cir., 1967, 375 F. 2d 393.

Plaintiff's position as shareholders suing derivatively on behalf of National American differs from their position as individuals suing in their own right, for they do allege that National American has purchased securities in connection with the fraud alleged, and the shareholder bringing a derivative action need not personally be a purchaser or seller. *E. g.*, **Rekant v. Desser**, 5 Cir., 1970, ... F. 2d ... [No. 25872, April 20]; **City National Bank of Fort Smith v. Vanderboom**, 8 Cir., 1970, 422 F. 2d 221. Our inquiry consequently extends to whether count one alleges facts amounting to a "purchase" by National American within the meaning of section 16(b) and Rule 10b-5.

Plaintiffs contend that their corporation has standing to invoke the Rule 10b-5 right of action as a result of defendants' scheme to cause a merger into one company of National American, Alabama National, and another Arizona Group corporation on terms disadvantageous to National American. The alleged effect of the merger, when it takes place, will be to cause National American to acquire ownership of Wilder's control stock (both his First Colonial stock and his National American stock) at the

premium price negotiated by the Arizona Group. Notwithstanding that the merger of the corporations has not yet been completed, plaintiffs argue that National American is a statutory "purchaser" entitled to damages under Rule 10b-5 for harmful acts already committed in furtherance of the plan to effect the merger. As authority for their proposition that damages may be awarded under Rule 10b-5 even though the securities transaction giving the plaintiff standing to sue has not been completed, plaintiffs rely upon **Opper v. Hancock Securities Corporation**, 2 Cir., 1966, 367 F. 2d 157, **aff'g.** S. D. N. Y., 1965, 250 F. Supp. 668, and **Goodman v. H. Hentz & Co.**, N. D. Ill., 1967, 265 F. Supp. 440.[13]

In **Opper** a customer sued a brokerage house for damages allegedly resulting from the latter's failure to carry out his order to sell certain securities while the house was disposing of large amounts of similar securities it had held for its own account. The customer eventually sold his securities at a substantial loss. The Second Circuit, in affirming a judgment for the customer, stated, "Failure to carry out the order while disposing of its own similar stock was not only actionable under the contract but also a violation of the Securities Exchange Act." 367 F. 2d at 158. That the Court did not particularize the violation committed makes **Opper** less persuasive than it otherwise might be in this case, since the customer in **Opper** proceeded on the theory that the brokerage house had violated section 15(c)(1) of the Exchange Act, as well as section 10(b). Moreover, even if **Opper** refers to section 10(b), it, like **Stockwell v. Reynolds & Co.**, S. D. N. Y., 1965, 252 F. Supp. 215, 219, appears relevant in the present context only as support for the proposition that section 10(b) and Rule

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[13] Plaintiffs also rely upon Barnett v. United States, 8 Cir., 1963, 319 F. 2d 340. That case, however, came to the Eighth Circuit on petition for review of an SEC order revoking the registration of a company as a broker-dealer and has little, if any, application in the context of private actions.

10b-5 do not require that the plaintiff's purchase or sale immediately follow the defendant's fraud; it is not authority for the propositions that Rule 10b-5 does not require a statutory "purchase" or "sale" and that a private plaintiff need not be a statutory "purchaser" or "seller."

In **Goodman** another customer-broker case, it was alleged that the broker had "sold" the customer nonexistent securities. The District Court upheld the customer's right to sue under Rule 10b-5 over the broker's argument that the Rule requires a completed purchase or sale of securities. 265 F. Supp. at 444. Since there could be no completed transaction, in a common-law sense, in a case involving the purported sale of nonexistent securities, the **Goodman** Court arguably was dispensing with the requirement of a securities transaction by the plaintiff in a Rule 10b-5 action. However, the Court further said that "[P]laintiffs were actual parties to transactions which, for the fraud of [defendant], would have been actual purchases or sales . . ." *Id.* **Goodman**, therefore, rather than dispensing with the necessity of a "purchase" or "sale" of securities by the plaintiff in a Rule 10b-5 action, is consistent with the well-established proposition that a statutory "purchase" or "sale" is not necessarily a technical purchase or sale in common-law parlance. See, *e. g.*, **Mader v. Armel**, 6 Cir., 1968, 402 F. 2d 158; **Dasho v. Susquehanna Corporation**, 7 Cir., 1967, 380 F. 2d 262; **Hooper v. Mountain States Securities Corporation**, 5 Cir., 1960, 282 F. 2d 195.

Unlike **Opper** and **Goodman**, customer-broker cases involving the sort of frauds associated with trading in the securities markets, count one catalogs a series of acts traditionally dealt with under state law as instances of corporate mismanagement or breaches of fiduciary duties in the corporate context. Plaintiffs seek to link these acts in a chain subject to federal law by their allegation

of an overall scheme to defraud National American in connection with the planned merger of the latter. The broad purpose of this scheme, plaintiffs say, was to transfer control of National American from Wilder to the Arizona Group for a premium payable out of the assets of National American itself.

We begin by recognizing that violators of section 10(b) and Rule 10b-5 are not immunized from civil liability for their unlawful acts merely because these acts were committed as part of a broader scheme of corporate mismanagement. **Rekant v. Desser**, 5 Cir., 1970, ... F. 2d ... [No. 25872, April 20]; see, *e. g.*, **O'Neill v. Maytag**, 2 Cir., 1964, 339 F. 2d 764, 768; **New Park Mining Company v. Cranmer**, S.D.N.Y., 1963, 225 F. Supp. 261, 266. Also, the legality of the entire scheme, under federal and state law, may in certain circumstances be determined by a federal court in an exercise of its pendent jurisdiction. *E. g.*, **Errion v. Connell**, 9 Cir., 1956, 236 F. 2d 447.

State law mismanagement claims cannot be transformed into federal claims under Rule 10b-5, however, merely by means of general conclusionary allegations where one would otherwise not exist. See, **Lester v. Preco Industries, Inc.**, S.D.N.Y., 1965, 282 F. Supp. 459, 462; 6 Loss, Securities Regulation 3631 (Supp. 2d ed. 1969); **cf. Jewell v. City of Covington, Ga.**, 5 Cir., 1970, ... F. 2d ... [No. 28089, April 20]. Section 10(b) is not concerned so much with fraud per se as it is with the effect of fraud upon investors and upon the public interest in the maintenance of free and open securities markets nurtured in a climate of fair dealing. 48 Stat. 881; see, *e. g.*, **Kahan v. Rosenstiel**, 3 Cir., 1970, 424 F. 2d 161, 173; **SEC v. Texas Gulf Sulphur Co.**, 2 Cir., 1968, 401 F. 2d 833, 858-860 (en banc); **Hooper v. Mountain States Securities Corporation**, 5 Cir., 1960, 282 F. 2d 195, 202; **Superintendent of Ins. of St. of N. Y. v. Bankers Life & C. Co.**, S.D.N.Y., 1969, 300 F. Supp. 1083, 1101. Unless the plaintiff has standing to sue

for the rule violation he alleges and states a claim for relief under the rule, he must seek redress for the alleged fraud of the defendants under state law.

To state a Rule 10b-5 claim in a case involving the sort of scheme allegedly employed in this case in violation of the rule, a plaintiff must frame his complaint so that it appears with reasonable clarity therefrom either that a purchase or sale of securities by the plaintiff is the subject of the fraudulent scheme or that the inducement of such a purchase or sale is a purpose of the scheme. That the conduct complained of may be reprehensible does not require the conclusion that a federal remedy must be furnished. **Iroquois Industries, Inc. v. Syracuse China Corporation,** 2 Cir., 1969, 417 F. 2d 963, 969. The rights and remedies provided by the Securities Exchange Act are to serve "in addition to any and all other rights and remedies that may exist at law or in equity . . ." Securities Exchange Act of 1934, § 28(a), 15 U. S. C., § 78bb. If Congress had intended that the federal courts inquire into every decision affecting the management of corporations and then fashion a new federal law superseding state law on the fiduciary responsibilities of corporate directors, officers, and controlling persons, presumably so revolutionary a federal intervention into an area traditionally handled by the states would have been clearly expressed. **See Kaminsky v. Abrams,** S. D. N. Y., 1968, 281 F. Supp. 501, 504-505. **See also** 1 Loss, Securities Regulation 121-129 (2d ed. 1961).

In the present case, plaintiffs allege a broad scheme to defraud National American, involving corporate waste, deprivation of corporate opportunity, and the like, which, plaintiffs say, results or will result in an acquisition of securities by the corporation through a merger. We must ask whether defendants' alleged conduct is the type of fraudulent behavior which was meant to be forbidden by section 10(b) and Rule 10b-5. Affidavits and attached pa-

pers made available to this Court by both sides to the litigation indicate that plaintiffs have grounds upon which to allege that defendants have caused the National American board of directors to resolve that the merger with Alabama National and the other Arizona Group corporation be effected on the disadvantageous terms stated above.[14] The precise question presented, therefore, is whether, on these additional facts, National American is a "purchaser" or "seller" of securities for purposes of the section and the rule.

Under the circumstances of this case, we conclude that the resolution to merge is not unlike a partially consummated contract to buy or sell securities, and that, consequently, the broad antifraud purposes of 10(b) and 10b-5 would be clearly furthered by their application to this situation. **See** Securities Exchange Act of 1934, § 3(a)(13-14), 15 U. S. C. A., § 78c(a)(13-14); **SEC v. National Securities**, 393 U. S. 453, 467, 89 S. Ct. 564, 572 (1969). Shareholders approving a merger have been deemed "purchasers" of securities for purposes of the section and the rule, **SEC v. National Securities**, 393 U. S. 453, 467, 89 S. Ct. 564, 572 (1969), and a merged corporation has been deemed a "purchaser"-"seller." *E. g.*, **Dasbio v. Susquehanna Corporation**, 7 Cir., 1967, 380 F. 2d 262, 267. In both situations, the persons allegedly injured were required to make decisions regarding the merits of transactions in securities. Here, facts have been adequately alleged upon which it can be contended that the National American board's determination to merge was not such as a reasonable man would make if possessed of all the material information known to the other party to the

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[14] The papers submitted purport to document, among other matters, the agreement, as amended, between Wilder and NSI, the National American board meeting approving the merger plan, other aspects of the merger, and the disposition of Wilder's First Colonial and National American stock since the agreement between Wilder and NSI was first made.

transaction in this instance, the Arizona Group acting through its other corporations. As we have said in the Alabama National case decided today:

> "... When a person who is dealing with a corporation in a securities transaction denies the corporation's directors access to material information known to him, the corporation is disabled from availing itself of an informed judgment on the part of its board regarding the merits of the transaction. In this situation the private right of action recognized under Rule 10b-5 is available as a remedy for the corporate disability. We can make no meaningful distinction between this situation and [one in which] the other party to the securities transaction controls the judgment of all the corporation's board members or conspires with them or the one controlling them to profit mutually at the expense of the corporation, [for] the corporation is no less disabled from availing itself of an informed judgment than if the outsider had simply lied to the board. ..."

Shell v. Hensley, 5 Cir., 1970, ... F. 2d ... [Nos. 27447 and 27514, ...]. In short, we think that where, as here, the defendants control all the corporations to be merged, it is unnecessary to require as a condition precedent to a Rule 10b-5 action for damages by one of the corporations that the merger already be consummated, provided, of course, that the corporation can show that it was directly and proximately injured by the defendants' fraud or deceit in connection with the resolution to merge.

We have said that only purchasers or sellers of securities involved in an alleged Rule 10b-5 violation—that is, securities in connection with which fraud has allegedly been committed—can show injury of the type the rule is meant to prevent. It is they who have suffered legal injury as a result of a rule violation which is compensable

in a private action. Section 28 (a) of the Exchange Act provides that "[N]o person permitted to maintain a suit for damages under the provisions of this [Act] shall recover, through satisfaction of judgment in one or more actions, a total amount in excess of his actual damages on account of the act complained of." 15 U. S. C., § 78bb(a). **Compare** Securities Exchange Act of 1934, § 28(a), 15 U. S. C., § 78bb(a), **with** Clayton Act, § 4, 15 U. S. C., § 15. **See** also **Green v. Wolf Corporation**, 2 Cir., 1968, 406 F. 2d 291, 302-303. The gist of the Rule 10b-5 action for damages is economic injury to the plaintiff resulting proximately from the acts of the defendants which constitute a violation of the rule. **Cf. Winckler & Smith Citrus Products Co. v. Sunkist Growers, Inc.**, 9 Cir., 1965, 346 F. 2d 1012; **Association of Western Railways v. Riss & Company**, D. C. Cir., 1962, 299 F. 2d 133. In this case, plaintiffs allege that defendants have damaged National American in many ways by acts committed to further their overall conspiracy involving the sale of control of National American. Their action is not based merely upon the existence of the conspiracy. SEC Rule 10b-5(1), 17 C. F. R., § 240.10b-5(1), but rests also upon the damage they allege has resulted to National American from those acts of defendants which are found to constitute the employment of manipulative or deceptive devices or contrivances "in connection with" a purchase or sale by the corporation. Such damage is the legal injury to National American which is compensable under the rule. As we have indicated, plaintiffs do have grounds for alleging a statutory "purchase" or "sale" by their corporation. On remand, therefore, it must be determined whether National American, as a "purchaser" or "seller," has been proximately injured by acts amounting to the employment by defendants of a scheme to defraud the corporation in violation of the rule. The question whether the acts complained of in count one constitute a consistent course of conduct carried on to defraud National Amer-

sion in connection with the latter's transaction in securities, and whether this transaction is the subject of all or a part of the overall scheme, goes to the merits of plaintiffs' case, not to the issue whether plaintiffs have stated a claim upon which relief can be granted under section 10(b) and Rule 10b-5. Further proceedings are clearly necessary here.

B. Count Two

The fraud alleged in count two involves National American's purported purchase of worthless First Colonial stock from Harris for $100,000 by the pretext of a loan secured by a pledge of the stock actually purchased. Count two does not allege that the "loan" has been defaulted or that foreclosure on the stock has become necessary. Because such facts are not alleged, defendants argue that count two fails to allege a purchase of securities by National American. The question presented, consequently, is whether count two adequately states facts amounting to a 'purchase' within the meaning of section 10(b) and Rule 10b-5 so as to entitle plaintiffs to maintain a derivative action under the section and rule for damages and injunctive relief on behalf of their corporation.[15]

Given the reading **Conley v. Gibson**, 355 U. S. 41, 78 S. Ct. 99 (1957), requires, count two sufficiently avers, for purposes of withstanding a motion to dismiss made under Fed. R. Civ. P. 12(b), that the pledge agreement was pretextual, disguising a purchase in substance by National American of Harris' worthless stock.[16] Conse-

[15] Plaintiffs have not argued that they have an action in behalf of themselves and their class of National American shareholders on the facts alleged in count two.

[16] The count reads in pertinent part:

"1. On, to-wit, February 24, 1967, National American Life Insurance Company agreed to purchase for One Hundred Thousand Dollars ($100,000) from Luther D. Harris, then one of its directors, Twelve Thousand Nine Hundred Forty-

quently, we conclude that dismissal of count two cannot be sustained on the ground that neither plaintiffs nor their corporation has standing to bring a Rule 10b-5 action on the facts alleged in this count. See, e. g., **City National Bank of Forth Smith v. Vanderboom**, 8 Cir., 1970, 422 F. 2d 221.

Defendants argue that plaintiffs have not stated a claim under Rule 10b-5 because the complaint does not allege facts amounting to a deception of National American which is causally related to a purchase or sale of securities by the corporation. From the complaint, it appears that Harris, a director and "controlling person" of National American, entered into an agreement with the corporation in which the latter agreed to purchase worthless stock from the director. For the reasons we have expressed in **Shell v. Hensley**, 5 Cir., 1970, ... F. 2d ... [Nos. 27447 and 27514, ...], we conclude that dismissal of count two cannot be sustained on the ground that it fails to allege facts amounting to causal deceit. Accordingly, we must send this case back for the normal process of factual development and the determination of the real merits of the dispute. **Merlite Land, Sea & Sky, Inc. v. Palm Beach Investment Properties, Inc.**, 5 Cir., 1970, ... F. 2d ... [No. 28585, March 19].

C. Count Three

Plaintiffs contend that count three sufficiently alleges a fraud on National American in connection with a purchase by it of securities. The allegations from which plaintiffs

> Seven (12,947) shares of the common stock of First Colonial Corporation of America, which were then and are now worth less.
>
> "2. In order to conceal the true nature of said transaction, papers were drawn to indicate that the transaction was a loan. . . ."

Elsewhere in the count it is alleged that the First Colonial stock was "worthless."

claim a securities purchase by National American should be gleaned are as follows: Latta borrowed money from an unnamed person in order to purchase Dawl stock and caused National American to guarantee this loan; Latta then pledged the Dawl stock he had purchased as security for the loan; subsequently, Latta exchanged his Dawl stock for First Colonial stock and caused National American to agree to a substitution of the First Colonial stock for the Dawl stock as security for the loan, even though the First Colonial stock was not worth the amount owed on the loan. Plaintiffs' position, apparently, is that National American, by virtue of its role as the guarantor of the loan to Latta, became a "purchaser" of securities when Latta pledged the stock he bought as collateral for the loan. Plaintiffs base their argument upon the Second Circuit's decision in **SEC v. Guild Films Co.**, 2 Cir., 1960, 279 F. 2d 485.

The **Guild Films** case arose under the Securities Act of 1933. There an individual caused a corporation he controlled to purchase from Guild Films unregistered stock in that company. He purported to take the stock for investment only, and a restriction to this effect was stamped on the certificates. Subsequently, this individual caused the stock to be pledged to certain banks as additional collateral for his already overdue personal notes. Upon his default, the banks attempted to sell the unregistered stock. The SEC then sought to enjoin the sale by the banks. Concluding that the banks were "underwriters" within the meaning of section 2(11) of the Securities Act, the Second Circuit stated:

> "The banks cannot be exempted on the ground that they did not 'purchase' within the meaning of § 2(11). The term, although not defined in the [Securities] Act, should be interpreted in a manner complementary to 'sale' which is defined in § 2(3) as including 'every . . . disposition of . . . a security or interest in a

> security, for value . . . .' In fact, a proposed provision of the Act which expressly exempted sales 'by or for the account of a pledge holder or mortgagee selling or offering for sale or delivery in the ordinary course of business and not for the purpose of avoiding the provisions of the Act, to liquidate a bona fide debt, a security pledged in good faith as collateral for such debt,' was not accepted by Congress."

279 F. 2d at 489 (citations omitted).

Guild Films is factually distinguishable in material respects from the situation alleged in count three. Here, there is no allegation that the loan has been defaulted or that foreclosure on the pledged stock has become necessary. It is not alleged that National Securities has paid anything for the purported interest in Latta's securities it holds. Moreover, it is not alleged that National American was the pledgee; rather, the corporation was the guarantor of the pledgor. Apart from these distinctions, whatever the term "sale" means in section 2(11) of the Securities Act, we are here concerned only with whether the purposes of section 10(b) of the Exchange Act and Rule 10b-5 thereunder would be advanced by their application to the sort of loan guarantee pledge series of transactions presented in this case. Liberally viewed, count three shows that the effect of the fraud alleged is an extension of National American's credit on Latta's behalf. So far as the complaint reveals, this extension was made coincidentally with a stock purchase by Latta. It is not alleged that the corporate decision to make the extension was made in connection with Latta's personal transaction. On these facts, we conclude that defendants' behavior in causing this extension, even if proved to be as alleged, is not the type of fraudulent conduct which was meant to be forbidden by the section and the rule. **See SEC v. National Securities, Inc.**, 393 U. S. 453, 467, 89 S. Ct. 564,

572 (1969). Therefore, National American is not a "purchaser" of securities which is entitled to bring an action under section 10(b) and Rule 10b-5 on the facts alleged in count three.

We leave to the District Court on remand the determinations whether the claims presented in count three are within the court's pendent jurisdiction. **United Mine Workers of America v. Gibbs**, 383 U. S. 715, 86 S. Ct. 1130 (1966); **see Kletschka v. Driver**, 2 Cir., 1969, 411 F. 2d 436, 450, and whether if new facts are brought to light in further proceedings, these facts entitle plaintiffs or their corporation to invoke the private right of action under section 10(b) and Rule 10b-5 for the conduct complained of in this count.

D. **Count Four**

In count four plaintiffs seek to enjoin defendants from consummating the merger of National American with Alabama National and one or more other Arizona Group companies. This merger allegedly will be disadvantageous to National American and its shareholders in that the merger calls for National American, in effect, to pay Wilder the sale-of-control premium negotiated by the Arizona Group and for the present National American shareholders to receive stock in the post-merger corporation which is worth less than their National American stock is worth now. Count four also alleges in conclusionary terms that solicitations misleading in some way not pleaded have been mailed to National American shareholders to obtain proxies supporting the election of Arizona Group nominees to the National American board of directors.

Injunctive relief may be awarded to a private plaintiff under Rule 10b-5 in a proper case. *E. g.*, **Kahan v. Rosenstiel**, 3 Cir., 1970, 424 F. 2d 161; **Britt v. Cyril Bath Com-**

pany, 6 Cir., 1969, 417 F. 2d 433; **Mutual Shares Corporation v. Genesco, Inc.**, 2 Cir., 1967, 384 F. 2d 540. Such relief is available to undo a merger effected in violation of Rule 10b-5. **SEC v. National Securities**, 393 U. S. 453, 89 S. Ct. 564 (1969); **Dasho v. Susquehanna Corporation**, 7 Cir., 1967, 380 F. 2d 262. No reason is apparent why, under appropriate circumstances, an injunction cannot also be obtained to prevent the completion of a merger that is in the process of being effected in violation of the rule. Under the circumstances of this case, including the information presented to this Court by the parties, we conclude that plaintiffs have stated a 10b-5 claim for relief on behalf of National American in count four. Our conclusion is reached for the reasons we have expressed in regard to the allegations of count one. Whether an injunction would be premature in this case, as defendants suggest, can be determined only after the facts have been developed. Compare **Kohn v. American Metal Climax, Inc.**, E. D. Pa., 1970, ... F. Supp. ... [Civ. No. 70-933, June 8]. Further proceedings are, therefore, necessary. Since the relief plaintiffs seek in count four is obtainable in a derivative action, we do not reach the question whether plaintiffs also have standing in their own right under section 10(b) and Rule 10b-5 to seek this relief.

IV

This Court has not previously had occasion to consider whether a private right of action exists for violations of the Investment Company Act of 1940. 15 U. S. C., § 80a-1 *et seq.* The Second, Third, and Tenth Circuits have recognized such a right. **Brown v. Bullock**, 2 Cir., 1961, 294 F. 2d 415 (en banc); **Taussig v. Wellington Fund, Inc.**, 3 Cir., 1963, 313 F. 2d 472; **Esplin v. Hirschi**, 10 Cir., 1968, 402 F. 2d 94. Only the Eighth Circuit has reached the opposite conclusion. **Brouk v. Managed Funds, Incorporated**, 8 Cir., 1961, 286 F. 2d 901, vacated as moot, 369

U. S. 424, 82 S. Ct. 873 (1962), and that Court has indicated that a different result might obtain in a proper case. **Greater Iowa Corporation v. McLendon**, 8 Cir., 1967, 378 F. 2d 783, 793.

The history of the investment company industry prior to the passage of the Investment Company Act has been well summarized as follows:

> "Born in boom times, weaned upon the 1929 crash, and plagued with a fringe of thoroughly dishonest manipulators, the . . . industry grew without any effective regulation . . . to reap the whirlwind . . . [T]he picture presented by the Securities and Exchange Commission after a four year investigation showed fantastic abuse of trust by management and wholesale victimizing of investment company security holders. In general the abuses stemmed from the control of investment companies by banking, brokerage, or dealer interests a control founded in complicated capital structures, disguised behind meager, and often misleading, reports to stockholders, and exercised to benefit the sponsor without regard to any stewardship on behalf of the investors who put up the money."

Comment, **The Investment Company Act of 1940**, 50 Yale L. J. 440, 441-442 (1941).[17] Determining that the disclo-

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[17] One commentator enumerated some of the abuses as follows:

> ". . .[I]n some instances investment companies were looted by strong-arm tactics involving actual fraud or larceny, and in other cases much the same result was obtained by a widespread employment of most of the known corporate abuses—the formation of companies on 'shoestring' capital; the use of broad charter provisions relative to powers of management and the corporate purpose; the inclusion of exculpatory clauses to shield mismanagement; the failure of sponsors and officers to make capital contributions to some extent, at least, commensurate with their position in the company; perpetuation of control by such persons through proxy solicitations, staggered elections, and

sure treatment of the 1933 and 1934 Acts was insufficient to prevent these abuses, Congress meant by the Investment Company Act to establish a comprehensive scheme for regulating issuers of securities which engage in the business of investing and trading in the securities of others. See 1 Loss, Securities Regulation 144-147 (2d ed. 1961). The technique of the Act is to require registration with the SEC of all investment companies that use the mails or interstate facilities, with registration serving as the handle for the regulatory scheme. Section 7 of the Act imposes the penalty of exclusion from all channels of interstate commerce of investment companies that fail to register in compliance with section 8. 15 U. S. C., §§ 80a-7, 80a-8, and contracts made by unregistered companies are subject to the voiding provisions of section 47(b). 15 U. S. C., § 80a-46(b). The other sections of the Act concern the regulation of registered companies.

In the present case, plaintiffs allege that First Colonial is, and holds itself out to the public as being, an "investment company" within the meaning of section 3 of the Investment Company Act. 15 U. S. C., § 80a-3. They further allege that First Colonial has never complied with the registration provisions of section 8. Count one of the amended complaint avers that National American and its shareholders have been damaged as a result of various transactions that defendants have caused National American to enter into with First Colonial. Specifically, it is alleged that First Colonial was caused by defendants to dominate and control the affairs of National American in violation of section 7(a)(5) of the Act and to transact

seriatim resignations of directors; excessive promotional and managerial expenses; inadequate disclosure of company activities; the failure of dummy directors and others to fulfill their fiduciary duties; and the complexities caused by pyramiding and cross or circular ownership."

Note, **The Investment Company Act of 1940**, 41 Colum. L. Rev. 269, 273-274 (1941).

business with National American in interstate commerce in violation of section 7(a)(4), all to the damage of National American and its shareholders. Plaintiffs, on behalf of themselves and similarly situated National American shareholders and derivatively on behalf of National American, seek to bring an action under the Investment Company Act to enforce the duties and liabilities that act imposes upon defendants.

Defendants argue that the amended complaint fails to state a claim upon which relief can be granted under the Investment Company Act and that, in any event, plaintiffs lack standing to bring an action for the violations about which they complain. More particularly, defendants contend that the Act creates a private right of action only in favor of those who invest in the securities issued by investment companies and that a suit based upon nonregistration can be brought only if the plaintiff's damage is a direct result of the failure to register.

In deciding the question of standing, we assume that First Colonial is an "investment company" and is not exempted from the registration requirements of the Investment Company Act. We also assume, for the purpose of deciding this question, that the Investment Company Act affords a private right of action for injury suffered from its violation to the class of persons whose interest the Act was designed to protect. **Cf. Eastside Church of Christ v. National Plan, Inc.**, 5 Cir., 1968, 391 F. 2d 357, 362; **Goldstein v. Groesbeck**, 2 Cir., 1944, 142 F. 2d 422. We affirm the principle that private actions provide a necessary supplement to SEC action in the enforcement of the Investment Company Act. **J. I. Case Company v. Borak**, 377 U. S. 426, 432, 84 S. Ct. 1555, 1560 (1964). This does not mean, however, that anyone may assume the role of private policeman. Only persons showing injury of the type the Investment Company Act was meant to prevent may be afforded a civil remedy by the Act.

SEC v. General Time Corp., 2 Cir., 1968, 407 F. 2d 65, 71; **Greater Iowa Corporation v. McLendon**, 8 Cir., 1967, 378 F. 2d 783, 793 794. We turn, then, to consider the congressional purpose behind the Investment Company Act of 1940.

Section 1(a) of the Act presents the findings supporting the congressional conclusion that investment companies are affected with a national public interest. 15 U. S. C., § 80a 1(a). Section 1(b) declares that the national public interest and the interest of investors are adversely affected by various practices.[18] The enumerated practices found to have an adverse effect upon the national public interest and the interest of investors fall into the following categories: (1) failure to provide adequate, accurate information to prospective investors and shareholders in investment companies; (2) management of portfolios in the interests of managements and their affiliates rather than in the interests of the shareholders; (3) use of unsound,

[18] Such adverse effects are caused

"(1) when investors purchase, pay for, exchange, receive dividends upon, vote, refrain from voting, sell, or surrender securities issued by investment companies without adequate, accurate, and explicit information, fairly presented, concerning the character of such securities and the circumstances, policies, and financial responsibility of such companies and their management;

"(2) when investment companies are organized, operated, managed, or their portfolio securities are selected, in the interest of directors, officers, investment advisers, depositors, or other affiliated persons thereof, in the interest of underwriters, brokers, or dealers, in the interest of special classes of their security holders, or in the interest of other investment companies or persons engaged in other lines of business, rather than in the interest of all classes of such companies' security holders;

"(3) when investment companies issue securities containing inequitable or discriminatory provisions, or fail to protect the preferences and privileges of the holders of their outstanding securities;

"(4) when the control of investment companies is unduly concentrated through pyramiding or inequitable methods

misleading, and unsupervised accounting practices; and (4) changes in the character of the company's business without the consent of the shareholders. Mosley, Jackson, & Barnard, **Federal Regulation of Investment Companies Since 1940**, 63 Harv. L. Rev. 1134, 1140 n. 27 (1950). The purpose of the Act is to eliminate these abuses, 15 U. S. C., § 80a-1(b), through the accomplishment of five basic objectives. These objectives are (1) adequate safeguards for investors in the distribution and sale of investment company securities, (2) honest, unbiased management of investment companies, (3) greater participation in management by holders of investment company securities, (4) creation and maintenance of adequate feasible capital structures of such companies, and (5) transmittal of adequate financial statements and promulgation of uniform accounting rules. **See** 10 SEC Ann. Rep. 162 163 (1944), in 1 Loss, Securities Regulation 149 152 (2d ed. (1961)). The scheme of regulation designed to accomplish the statutory purpose, as indicated above, is pegged upon registration with the SEC of all investment companies doing business in interstate commerce which are not entitled to some exemption.

> of control, or is inequitably distributed, or when investment companies are managed by irresponsible persons;
>
> "(5) when investment companies, in keeping their accounts, in maintaining reserves, and in computing their earnings and the asset value of their outstanding securities, employ unsound or misleading methods, or are not subjected to adequate independent scrutiny;
>
> "(6) when investment companies are reorganized, become inactive, or change the character of their business, or when the control or management thereof is transferred, without the consent of their security holders;
>
> "(7) when investment companies by excessive borrowing and the issuance of excessive amounts of senior securities increase unduly the speculative character of their junior securities; or
>
> "(8) when investment companies operate without adequate assets or reserves."

15 U. S. C., § 80a-1(b).

The Investment Company Act was the fifth in a series of federal statutes designed to eliminate certain abuses in the securities industry, abuses that were found to have contributed to the 1929 financial crash and the depression of the 1930's. It was preceded by the Securities Act of 1933, 15 U. S. C., § 77a *et seq.*, the Securities Exchange Act of 1934, 15 U. S. C., § 78a *et seq.*, the Public Utility Holding Company Act of 1935, 15 U. S. C., § 79 *et seq.*, and the Trust Indenture Act of 1939, 15 U. S. C., § 77aaa *et seq.* Like the earlier statutes, the Investment Company Act was meant to provide another step toward a return to the understanding that those who manage other people's money are trustees acting for others. **Cf. SEC v. Capital Gains Research Bur.**, 375 U. S. 180, 186, 84 S. Ct. 275, 280 (1963); S. Rept. No. 47, 73d Cong., 1st Sess. 7 (1933) (presidential message to Congress). From a reading of the "Findings and Declarations of Policy" in section 1, as well as of the substantive provisions of the Act, we think it is clear in light of the circumstances under which the Act was passed that Congress intended to provide a comprehensive regulatory scheme to correct and prevent certain abusive practices in the management of investment companies for the protection of persons who put up money to be invested by such companies on their behalf.

Plaintiffs in the present case do not allege in count one that they or National American hold any ownership interest in First Colonial, the alleged investment company. Plaintiffs' theory is that where an unregistered investment company such as First Colonial dominates another company, in violation of section 7(a)(5) of the Investment Company Act, 15 U. S. C., § 80a-7(a)(5), to the detriment of the dominated company and to the benefit of the unregistered company, a private right of action under the Investment Company Act should be afforded to shareholders of the dominated company. We consider this theory unsound. In relation to First Colonial, plaintiffs

and their class stand as fellow shareholders of National American. In essence, plaintiffs are complaining about the mismanagement of National American which allegedly has been effected by a controlling shareholder (First Colonial). The history and whole pattern of the Investment Company Act convince us that Congress by this statute intended to deter mismanagement of investment companies for the protection of investment company security holders, **see, e. g., Greater Iowa Corporation v. McLendon**, 8 Cir., 1967, 378 F. 2d 783; **Verrey v. Ellsworth**, S. D. N. Y., 1969, 303 F. Supp. 497, not to regulate the management of companies in which investment companies put their funds. The latter purpose may be served by resort to the other federal securities laws, the antitrust laws, and the like. If any legally protected rights of plaintiffs or their corporation have been invaded as a result of an exercise by defendants of First Colonial's controlling interest in National American, plaintiffs must look elsewhere than to the Investment Company Act for a remedy. To be sure, section 7(a)(5) prescribes First Colonial's domination of National American, but plaintiffs have not alleged that, as a result of this violation, they or National American have suffered harm to any interest of theirs which is within the zone of interests protected by the Investment Company Act.[19] Therefore, we

[19] Plaintiffs also seek to bring an action under section 47(b) of the Investment Company Act, 15 U. S. C., § 80a-46(b). The language of section 47(b) establishes that violators and knowing successors in interest are precluded from enforcing contracts made in violation of the Act or any rule thereunder or where performance would involve such a violation. **Cf.** Mills v. Electric Auto-Lite Co., 396 U. S. 375, 90 S. Ct. 616, 623 (1970) (construing section 29(b) of the Exchange Act, an analogue to section 47(b) of the Investment Company Act). In this case, however, plaintiffs have not alleged that there was any contractual relation between National American and defendants herein which was made in violation of any section of the Investment Company Act. Consequently, we do not reach the question whether section 47(b), like section 29(b) of the Ex-

hold that plaintiffs lack standing to bring an action under the Investment Company Act on the facts alleged in count one.

V

We turn finally to defendants' contention that grounds independent of whether the District Court had subject-matter jurisdiction of plaintiffs' claims or whether plaintiffs stated any claims upon which relief can be granted exist for sustaining the judgment below. These grounds are (1) want of indispensable parties and (2) failure of plaintiffs to comply with all requirements for the maintenance of a shareholder's derivative action in federal court. Specifically, defendants argue that the decision below was correct because, under Fed. R. Civ. P. 19, the case could not proceed properly without Wilder and First Colonial as parties and because, under Fed. R. Civ. P. 23.1, plaintiffs did not make a demand for corrective action on the directors and shareholders of National American before bringing this derivative action on National American's behalf. We disagree with defendants' contentions.

The argument that Wilder and First Colonial should be described with the conclusionary term "indispensable parties" is without merit. **See generally Morrison v. New Orleans Public Service, Inc.**, 5 Cir., 1969, 415 F. 2d 419. The relief plaintiffs seek can be accorded from the defendants named in the complaint, these defendants are not left subject to a substantial risk of incurring double, multiple or otherwise inconsistent obligations by reason of the claimed interests of Wilder and First Colonial, and Wilder and First Colonial do not appear to be so situated

change Act. Eastside Church of Christ v. National Plan, Inc., 5 Cir., 1968, 391 F. 2d 357, 362, contemplates private actions for relief by innocent parties to contracts made in violation of the Investment Company Act or performed in violation of the Act.

that disposition of this action might as a practical matter impair or impede their ability to protect the interests defendants claim they have. Fed. R. Civ. P. 19(a). Rule 19, as amended in 1966, was not meant to unsettle the well-established authority to the effect that joint tortfeasors or coconspirators are not persons whose absence from a case will result in dismissal for nonjoinder. Advisory Committee's Note to Rule 19, in 39 F. R. D. 89, 91 (1966). **See also State of Georgia v. Pennsylvania R. Co.**, 324, U. S. 439, 65 S. Ct. 716 (1945); 2 Barron & Holtzoff, Federal Practice and Procedure, § 513.8 (Wright rev. ed. 1961, Supp. 1968).

The argument that plaintiffs have failed to comply with the demand requirements, such as they are, of Rule 23.1 similarly does not justify dismissal of the amended complaint. Rule 23.1 provides that in a shareholder's derivative action, the complaint shall allege "with particularity the efforts, if any, made by the plaintiff to obtain the action he desires from the directors . . . and, if necessary, from the shareholders . . . and the reasons for his failure to obtain the action or for not making the effort." Plaintiffs admit that a demand for corrective action was not made upon the National American board of directors or shareholders before this action was commenced, but argue that such demands would have been futile and unavailing. Under the circumstances alleged in the **Conley**-read complaint, we agree with plaintiffs. Accordingly, we conclude that plaintiffs cannot be foreclosed from maintaining this action on the ground that they have not complied with Rule 23.1.

The judgment is Affirmed in part and Reversed in part, and the case is Remanded for further proceedings in accordance with this opinion.

APPENDIX VI

In the
United States Court of Appeals
For the Fifth Circuit

No. 27447

Claude E. Shell
Petitioner-Appellant
versus
Milford E. Hensley
Respondent-Appellee

No. 27514

Jack E. Love, et al.
Petitioners-Appellants
versus
Milford E. Hensley, et al.
Respondents-Appellees

Appeals from the United States District Court for the
Northern District of Alabama

(July 14, 1970)

Before Ainsworth, Dyer and Simpson
Circuit Judges

Ainsworth, Circuit Judge: We must here determine, as in the **Herpich** cases[1] decided today, whether minority

[1] Herpich v. Wallace, 5 Cir., 1970, ... F. 2d ... [No. 27729, ...]; Herpich v. Wilder, 5 Cir., 1970, ... F. 2d ... [No. 27385, ...].

shareholders, this time of an Alabama corporation, have stated a claim for relief under various sections of the federal securities laws which entitles them to challenge in federal court, absent diversity, the way in which control of their corporation was sold to an Arizona-based complex of insurance companies. The District Court, deciding that this case should be accorded the normal process of factual development and a determination of the real merits of the case overruled defendants' motions to dismiss the complaint. An important issue with which we deal is the extent to which proof of deception is necessary to show a violation of SEC Rule 10b-5, 17 C. F. R., § 240.10b-5.

These are appeals from interlocutory orders,[2] consolidated by a panel of this Court, which overruled defendants' motions to dismiss the amended complaint filed against them in the court below.[3] Plaintiffs are shareholders of Alabama National Life Insurance Company, an Alabama corporation. They brought suit against Claude E. Shell (appellant in No. 27447), L. E. Cowling, National Securities, Inc. (NSI), Old National Insurance Company, Robert H. Wallace, and Jack E. Love. With the exception of Shell and Cowling, who is not a party to this appeal, defendants are members of the Arizona Group, the principal defendants in **Herpich v. Wallace**, 5 Cir. 1970, ... F. 2d ... [No. 27729, ...] and appellants in No. 27514 herein.

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[2] The District Judge, H. H. Grooms, determined that an immediate appeal from his order overruling defendants' motions to dismiss the complaint might materially advance the ultimate termination of this litigation in light of the decisions in Herpich v. Wilder, M. D. Ala., 1969 [Civ. No. 2747-N, January 14], **rev'd**, 5 Cir., 1970, ... F. 2d ... [No. 27385, ...], and Greenstein v. Paul, 2 Cir., 1968, 400 F. 2d 580. **See** 28 U. S. C., § 1292(b) (1964).

[3] No. 27514, styled "Love v. Hensley," should not be confused with Hensley v. Love, N. D. Ala., 1969, 298 F. Supp. 698, which is yet another of the Arizona Group cases being tried by Judge Grooms.

In the present case, the complaint, as amended, alleged violations of section 10(b) of the Exchange Act,[4] Rule 10b-5,[5] section 17(a) of the Securities Act of 1933,[6] 15 U. S. C.,

[4] Section 10 of the Exchange Act, entitled "Regulation of the Use of Manipulative and Deceptive Devices," reads in relevant part as follows:

> "It shall be unlawful for any person, directly or indirectly, by the use of any means of instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange
>
> . . .
>
> "(b) To use or employ, in connection with the purchase or sale of any security . . ., any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."

[5] Rule 10b-5, entitled "Employment of Manipulative and Deceptive Devices," reads as follows:

> "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,
>
> "(1) to employ any device, scheme, or artifice to defraud,
>
> "(2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> "(3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
>
> in connection with the purchase or sale of any security."

[6] Section 17, entitled "Fraudulent Interstate Transactions," reads in part as follows:

> "(a) It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly—
>
> "(1) to employ any device, scheme, or artifice to defraud, or
>
> "(2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the

§ 77g(a), and applicable state law. Plaintiffs sought damages on behalf of Alabama National, themselves, and all Alabama National shareholders similarly situated. Federal jurisdiction was predicated upon section 27 of the Exchange Act, 15 U. S. C., § 78aa, and section 22 of the Securities Act, 15 U. S. C., § 77v.[7] Defendants filed motions to dismiss for lack of jurisdiction and for failure to state a claim upon which relief can be granted. The District Judge overruled these motions. He did, however, grant defendants' motion to strike the class action allegations from the amended complaint. The present status of the suit, consequently, is that of a derivative action brought on behalf of Alabama National under Fed. R. Civ. P. 23.1.

I

From the complaint, as amended, affidavits, and documents,[8] the facts, as alleged, appear as follows. Over a four-year period, Alabama National was defrauded in various ways by defendants, who acted in several combinations. Two periods of unlawful activity are presented: (1) 1965 until October 1967, during which time Shell and

> statements made, in the light of the circumstances under which they were made, not misleading, or
> "(3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser."

[7] Plaintiffs also sought to invoke the pendent jurisdiction of the District Court, **see**, *e. g.*, United Mine Workers of America v. Gibbs, 383 U. S. 715, 86 S. Ct. 1130 (1966), and cited 28 U. S. C., § 1337.

[8] After the Court had heard oral argument in this and the related Arizona Group cases decided today, both sides filed supplemental memoranda with the Clerk. Sworn affidavits and attached copies of purported documents were also filed by plaintiffs, who allege that they obtained the information filed as a result of discovery in other Arizona Group cases proceeding in the federal and state courts.

Cowling used the funds of Alabama or its subsidiary to finance transactions in securities between themselves, corporations they controlled, or both, for the purpose of enriching themselves at the expense of Alabama National; and (2) October 1967 and thereafter, during which time Shell formulated and carried out his agreement with the Arizona Group to sell control of Alabama National to the latter for a premium payable only to him.

A. 1965-October 1967

It is alleged that in April 1965, Shell, then the president and a director of Alabama National, and Cowling who was responsible for the incorporation and initial capitalization of Alabama National, caused the corporation to loan $432,000 to S & S Development Corporation, which Shell controlled. This loan, for which no security, or grossly inadequate security, was given, was made to finance the purchase by Shell or S & S from Cowling of 862,500 shares of stock in Capital Corporation of Texas. At all pertinent times until control of Alabama National was sold to the Arizona Group, both Shell and Cowling were "controlling persons," as that term is defined in the federal securities acts,[9] of Alabama National. Cowling was also a control

[9] The complaint reads in pertinent part as follows:

"7—at all times relevant, prior to January 16, 1968, defendant Claude E. Shell was president, a director, and a 'controlling person' as defined by the federal securities act of defendant Alabama National Life Insurance Company.

"8—Defendant L. E. Cowling was responsible for the founding and initial capitalization of Alabama National Life Insurance Company, Capital National Life Insurance Company of Houston, Texas, and Southern States Life Insurance Company, and on, to-wit, January 16, 1968 and at all times relevant prior thereto was a 'controlling person' as so defined of Alabama National Life Insurance Company and of Capital Corporation of Texas, which in turn owned enough stock of Alabama National Life Insurance Company to control the latter corporation."

ling person of Capital Corporation, which, in turn, was a controlling person of Alabama National. Capital Corporation held this control position at least partially as a result of its purchase of a substantial block of Alabama National stock from Cowling. Cowling had taken Capital Corporation's note in payment for these shares. In 1967, Bayou Land Corporation, a wholly owned subsidiary of Alabama National, was caused to loan Capital Corporation sums amounting to approximately $267,000 to enable the latter to pay Cowling interest that had accrued on this note. Like the loan from Alabama National to S & S, these advances were not secured by adequate collateral.

B. October 1967 and Thereafter

It is further alleged that during October 1967, Shell, Love, and Wallace conspired and agreed that Shell would sell shares of capital stock in Alabama National and Capital Corporation which were registered either in Shell's name or in the names of corporations he owned to NSI for $1,600,000. This price exceeded the market value of the stock and its cost to Shell, and the excess over market value represented a premium payable only to Shell for transferring control of Alabama National. In furtherance and according to the terms of their scheme, Shell and the Arizona Group caused the following to be done: First, Alabama National was, and is being, required to pay part of the premium going to Shell for selling control of Alabama National. This result was, and is being, accomplished in part through the contrivance of a nine-year employment contract granted by the corporation to Shell. This contract calls for Shell to perform part-time work at a salary of $50,000 a year, which is more than he received when employed as the full-time president of the corporation. In addition, Shell and the Arizona Group caused Alabama National to purchase at excessive prices from NSI certain

savings-and-loan stock, land, and a note secured by a mortgage; these transactions were effected so that NSI could use the money obtained from Alabama National to pay Shell for the sale of control. Secondly, Shell resigned his positions at Alabama National and used his best efforts to obtain the election of Wallace, Love, and Arizona Group designees as officers and directors of the corporation. Thirdly, Shell was not required to account to Alabama National for the payment received from NSI even though, as the conspirators knew, Shell had acquired the stock that NSI bought from him with funds he had borrowed from Alabama National while serving as an officer and director of the corporation. Fourthly, Alabama National was caused to assume certain obligations under a reinsurance agreement at no benefit to Alabama National, but to the benefit of the Arizona Group. Fifthly, defendants sent out misleading proxy materials, reports, and other mailings that served to deceive and lull Alabama National and its shareholders other than defendants. These statements included representations that the $50,000 to be paid Shell each year for nine years was for services rather than consideration for the sale of Shell's stock and omitted to disclose the true value of the savings-and-loan stock, land, and note bought by Alabama National from NSI or that Shell had a duty to account to Alabama National. Finally, defendants caused notices of the 1968 annual shareholders' meeting to be mailed so that they were not received by plaintiffs and their class of Alabama National shareholders until the day of the meeting, August 26, 1968.

Defendants characterize the complaint in this case as being in substance a claim of corporate waste or deprivation of corporate opportunity. They concede that this complaint may give rise to a state-law claim of fraud or breach of fiduciary duty, but contend that it may not be asserted in federal court absent diversity of citizenship between

the parties. First, it is argued, a claim of violations of section 10(b) and Rule 10b-5 is not stated because "causal deceit" is not alleged. Secondly, and in any event, plaintiffs personally and on behalf of Alabama National lack standing to complain of purported violations of the section and the rule.

For reasons that follow, we conclude that the complaint was sufficient to withstand defendants' motions to dismiss for want of jurisdiction and failure to state a claim upon which relief can be granted. Accordingly, without making any suggestion how this case should be determined on the merits, e. g., **Merlite Land, Sea & Sky, Inc. v. Palm Beach Investment Properties, Inc.**, 5 Cir., 1970, ... F. 2d ... [No. 28565, March 19]; **Exhibitors Poster Exchange, Inc. v. National Screen Serv. Corp.**, 5 Cir., 1970, ... F. 2d ... [No. 26643, January 26], we affirm the judgment of the District Court in the appeals numbered 27447 and 27514.

II

The threshold question we must determine is whether plaintiffs have standing to enforce the violations of section 10(b) and Rule 10b-5 which they allege in their complaint.[10] **See Herpich v. Wallace**, 5 Cir., 1970, ... F. 2d ... [No. 27729, ...]. We conclude that plaintiffs, as shareholders of Alabama National, may sue the Arizona

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[10] Violations of section 17(a) of the Securities Act of 1933, 15 U. S. C., § 77q(a), are also alleged. In this case, however, we need not reach the question whether an implied right of action should be recognized for violations of section 17(a), since section 10(b) of the Exchange Act and Rule 10b-5 thereunder will support as well as would section 17(a) an action for any monetary or injunctive relief to which plaintiffs or their corporation may be entitled. **See**, *e. g.*, Globus v. Law Research Service, Inc., 2 Cir., 1969, 418 F. 2d 1276, 1283. **See also** 3 and 6 Loss, Securities Regulation 1778-1791 (2d ed. 1961), 3907-3915 (Supp. to 2d ed. 1969). Consequently, we pretermit discussion of section 17(a) in this opinion.

Group and Shell derivatively on behalf of Alabama National under the section and the rule.

The individual right of action implied under Rule 10b-5 may be invoked on behalf of a corporation in a shareholder's derivative suit. **E. g., Herpich v. Wallace**, 5 Cir., 1970, ... F. 2d ... [No. 27729, ...]; **Rekant v. Desser**, 5 Cir., 1970, ... F. 2d ... [No. 25872, April 20]; **City National Bank of Fort Smith v. Vanderboom**, 8 Cir., 1970, ... F. 2d ... [Nos. 19550-19554, February 20]; **Condon v. Richardson**, 7 Cir., 1969, 411 F. 2d 489; **Schoenbaum v. Firstbrook**, 2 Cir., 1968, 405 F. 2d 215 (en banc). The shareholder who brings a derivative suit under the rule need not personally be a statutory "purchaser" or "seller". It suffices, for the purpose of establishing standing to sue, that the shareholder allege that his corporation has "purchased" or "sold" securities in connection with some fraudulent activity. **Herpich v. Wallace**, 5 Cir., 1970, ... F. 2d ... [No. 27729, ...]; **City National Bank of Fort Smith v. Vanderboom**, 8 Cir., 1970, ... F. 2d ... [Nos. 19550-19554, February 20]; **Surowitz v. Hilton Hotels Corporation**, 7 Cir., 1965, 342 F. 2d 596, 604, **rev'd on other grounds**, 383 U. S. 363, 86 S. Ct. 845 (1966).

The complaint in the present case alleges that Alabama National has been defrauded in connection with its purchase at excessive prices from NSI of, among other things, 219,687 shares of stock in Southwest Savings & Loan Association. In the context of defendants' motions to dismiss the complaint, this allegation, which must be taken as true, **Walker Process Equip. v. Food Mach. & Chem. Corp.**, 332 U. S. 172, 86 S. Ct. 347 (1965); **Cliff Food Stores, Inc. v. Kroger, Inc.**, 5 Cir., 1969, 417 F. 2d 203, suffices to give Alabama National, and its shareholders suing derivatively, standing to bring an action under section 10(b) and Rule 10b-5. **Herpich v. Wallace**, 5 Cir., 1970, ... F. 2d ... [No. 27729, ...]; **cf. Tcherepnin v.**

Knight, 389 U. S. 332, 88 S. Ct. 548 (1967); Securities Exchange Act of 1934, ... §§ 3(a)(10), 3(a)(13), 15 U. S. C., §§ 78c(a)(10), 78c(a)(13).[11]

III

The complaint, in addition to declaring that plaintiffs did not discover the wrongs committed by defendants until August 1968, asserts that (1) Alabama National and its shareholders were deceived regarding the true nature of Shell's so-called employment contract, (2) Shell's duty to account to Alabama National was not disclosed in proxy and other mailings, and (3) the true value of the securities and land purchased by Alabama National from NSI was concealed. Defendants contend that the complaint fails to state a cause of action under section 10(b) and Rule 10b-5 because it does not allege facts amounting to "deception" of Alabama National in connection with

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[11] Section 3(a) (10) reads as follows:

> "The term 'security' means any note, stock, treasury stock, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit, for a security, or in general, any instrument commonly known as a 'security'; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase, any of the foregoing; but shall not include currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited."

Section 3(a) (13) reads as follows:

> "The terms 'buy' and 'purchase' each include any contract to buy, purchase, or otherwise acquire."

These definitions apply when the terms "security," "buy," and "purchase" are used in the Exchange Act "unless the context otherwise requires." 15 U. S. C., § 78c(a).

purchases of securities by Alabama National. Plaintiffs respond that deception is adequately alleged and that, in any event, proof of deception is not required in an action brought under sub-sections (1) and (3) of Rule 10b-5. We are thus called upon to consider the extent to which proof of deception must be shown in order to establish a cause of action under the section and the rule. In deciding this case, we are mindful that we venture into an area of law where "glib generalizations and unthinking abstractions are major occupational hazards," **SEC v. National Securities**, 393 U. S. 453, 465, 89 S. Ct. 564, 571 (1969), and a cautious, case-by-case approach is necessary to the proper development of controlling precedent. **Herpich v. Wallace**, 5 Cir., 1970, ... F. 2d ... [No. 27729, ...]. Consequently, we inquire herein whether defendants' conduct, if proved to be as plaintiffs allege, is the type of behavior which was meant to be prohibited by the section and the rule. **SEC v. National Securities**, 393 U. S. 453, 467, 89 S. Ct. 564, 572 (1969).

Shell and the Arizona Group argue that plaintiffs have not stated a claim under Rule 10b-5 because the complaint does not allege either (1) that members of the Alabama National board of directors were deceived in any way in connection with the corporation's purchase or sale of securities or (2) that Shell, one member of an eleven man board, or the Group controlled the actions of a majority of the board. Unlike defendants, we find that a Rule 10b-5 claim has been stated. The complaint alleges a conspiracy between the Arizona Group and Shell to defraud Alabama National by causing the corporation directly, and indirectly through its purchase of securities, to provide the inducement to Shell to sell control of Alabama National to the Group. This inducement allegedly was cast in the form of (1) a sham employment contract that Alabama National was caused to enter with Shell and (2)

a purchase by NSI of Shell's Alabama National and Capital Corporation stock representing the power to control Alabama National at a price in excess of the market value of this stock and its cost to Shell. Alabama National allegedly was caused to pay part of this inducement directly to Shell through the device of the long term employment contract. It allegedly was caused to pay part of the inducement indirectly to Shell through the device of its purchase of securities and other property from NSI at excessive prices, followed by NSI's use of the money received from Alabama National to pay Shell for his stock. This behavior on the part of defendants, if proved, is of the sort that section 10(b) and Rule 10b 5 were meant to prevent.

The complaint affords defendants fair notice of what plaintiffs' claim is and the grounds upon which it rests. It does not appear beyond doubt that plaintiffs can prove no set of facts which would entitle their corporation to relief. Consequently, the District Court was correct in overruling defendants' motions to dismiss. **Conley v. Gibson**, 355 U. S. 41, 45-46, 78 S. Ct. 99, 102 (1957); **Cliff Food Stores, Inc. v. Kroger, Inc.**, 5 Cir., 1969, 417 F. 2d 203; **Pred v. Board of Public Instruction of Dade County**, 5 Cir., 1969, 415 F. 2d 851. Fairly read, the complaint alleges that defendants, directly or indirectly, caused at least a majority of the Alabama National board to act adversely to the interests of their corporation in connection with a securities transaction between Alabama National and NSI which was not conducted at arm's length. If proved to be as alleged, defendants' behavior violated section 10(b) and Rule 10b 5. **See Schoenbaum v. Firstbrook**, 2 Cir., 1968, 405 F. 2d 215 (en banc).

As used in the complaint,[12] the term "control" is a shorthand expression of the "power to direct or cause

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[12] **See** note 9, *supra*.

the direction of the management and policies of a person. . . . " SEC Rule 12b 2(f), 17 C. F. R., § 240.12b 2(f). **See also Susquehanna Corp. v. Pan American Sulphur Co.**, 5 Cir., 1970, 423 F. 2d 1075; Berle, **The Price of Power: Sale of Corporate Control**, 50 Cornell L. Q. 628, 630 (1965). Taking the allegations of the complaint as true, we find that Shell possessed "control" of Alabama National until mid January 1968. On January 19, 1968, he executed an agreement to sell his power over Alabama National to NSI and thereafter resigned as an officer and director of Alabama National. Then, on January 25, 1968, Alabama National was caused to purchase securities at an exorbitant price from NSI. NSI, having just acquired control of Alabama National from Shell, then possessed the "power to direct or cause the direction of the management" of its customer. The question whether the transaction between Alabama National and NSI was conducted at arm's length, with the Alabama National board of directors, goes to the merits of plaintiffs' case, not to the jurisdiction of the federal court or the sufficiency of the complaint to withstand a motion to dismiss for failure to state a claim. *

Under the facts alleged, the Arizona Group, acting through NSI, was in a position either to govern the judgment of the Alabama National board or to conspire with Shell to govern the board's judgment in connection with Alabama National's purchase of securities and other property from NSI. Defendants' reliance on the lack of an express allegation that any Alabama National director was deceived in connection with this purchase as a ground for dismissing the complaint is not warranted. To be sure, as a general statement of corporate law, a corporation can acquire knowledge only through its officers and agents and can know only what its officers and agents know. *E. g.*, **Bergeson v. Life Insurance Corporation of America**, 10

Cir., 1959, 265 F. 2d 227, 232; 3 Fletcher, Private Corporations § 790 (perm. ed. 1965); Restatement (Second) of Agency § 9(3) (1958). Arguably, therefore, if the corporation's officers or agents are not deceived, the corporation is not deceived, and a claim is not stated under section 10(b) and Rule 10b-5. **See O'Neill v. Maytag**, 2 Cir., 1964, 339 F. 2d 764. This contention rests upon the idea that the corporation should be treated as possessing the attributes of a person. Like other concepts of the corporate business organization, however, the anthropomorphic concept of the corporation a person capable of injury and knowledge is not a universal solvent for problems involving corporate relationships. **See**, *e. g.*, Andrews, **The Stockholder's right to Equal Opportunity in the Sale of Shares**, 78 Harv. L. Rev. 505, 538-545 (1965). In the present context, our predominant concern is with effectuating the remedial purposes of section 10(b), as implemented by Rule 10b-5. **SEC v. Capital Gains Research Bur.**, 375 U. S. 180, 195, 84 S. Ct. 275, 284-285 (1963). Conceptual analysis of corporate relationships must bow to that concern. **See Dasho v. Susquehanna Corporation**, 7 Cir., 1967, 380 F. 2d 262, 270 (Fairchild, J.); **Ruckle v. Roto American Corporation**, 2 Cir., 1964, 339 F. 2d 24, 29.

Defendants' position, by allowing all liability under section 10(b) and Rule 10b-5 to be foreclosed on the basis of a finding that all the Alabama National directors knew that they were causing their corporation to pay excessive consideration for securities and other property, would remove the corporation—and hence its shareholders—from the protection of the section and the rule merely because of the ease with which defendants victimized it. The result would be to permit those dealing with a corporation to practice the basest sort of chicanery in connection with securities transactions they enter into with that corporation. They would need only to hold sway over the

corporation's directors or cause them by other means to act adversely to the interests of the organization they were charged to manage. In such a situation, the corporation is deprived of the opportunity to engage in securities transactions in a "climate of fair dealing," **SEC v. Capital Gains Research Bur.**, 375 U. S. 180, 201, 84 S. Ct. 275, 288 (1963). Vindication of the congressional purpose to establish a climate of fairness for securities transactions is required in these circumstances by the section and the rule. When a person who is dealing with a corporation in a securities transaction denies the corporation's directors access to material information known to him, the corporation is disabled from availing itself of an informed judgment on the part of its board regarding the merits of the transaction. In this situation the private right of action recognized under Rule 10b-5 is available as a remedy for the corporate disability. We can make no meaningful distinction between this situation and the one at hand. When the other party to the securities transaction controls the judgment of all the corporation's board members or conspires with them or the one controlling them to profit mutually at the expense of the corporation, the corporation is no less disabled from availing itself of an informed judgment than if the outsider had simply lied to the board. In both situations the determination of the corporation's choice of action in the transaction in question is not made as a reasonable man would make it if possessed of all the material information known to the other party to the transaction.

Under the particular circumstances of this case, therefore, we conclude that an express allegation that Alabama National directors have been deceived in connection with the corporation's purchase or sale of securities is not a necessary element of a 10b-5 claim asserted on behalf of the corporation. It suffices, for purposes of stating a claim

under Rule 10b-5, that the complaint alleges that Alabama National, as a result of the conspiracy carried out by Shell and the Arizona Group, was caused to participate in a securities transaction in which it was prevented by both the other party and its own directors from taking advantage of the safeguards the disclosure requirements of the rule were meant to provide.[13]

The orders in Nos. 27447 and 27514 are Affirmed.

[13] With respect to Shell, the complaint alleges that this defendant committed acts in furtherance of the conspiracy between him and the Arizona Group. Having allegedly joined in the conspiracy and taken steps to assure its success, Shell may also be held accountable for the acts of his co-conspirators in furtherance of their scheme. Dasbio v. Susquehanna Corporation, 7 Cir., 1967, 380 F. 2d 262, 267, n. 2. Since we have concluded that plaintiffs have stated a 10b-5 claim on behalf of Alabama National, it is not necessary for us to consider other points raised by plaintiffs on this appeal.

APPENDIX VII

In the United States District Court for the
Northern District of Alabama,
Southern Division

Milford E. Hensley, on Behalf of All Stockholders of Alabama National Life Insurance Company, an Alabama Corporation, Plaintiff, vs. Claude E. Shell, et al., Defendants.	Civil Action No. 68-461

Order on Motions to Dismiss

(Filed Oct. 15, 1968)

The Court has heretofore taken under advisement the several motions to dismiss, and has carefully considered the authorities relied on by the parties. The main thrust of defendants' contention is that plaintiffs are not shown to have been sellers of the stock involved. **Birnbaum v. Newport Steel Corporation**, 2 Cir., 193 F. 2d 461, cert. denied 343 U. S. 956, followed in case of **Greenstein v. Paul**, decided by the Second Circuit on August 30, 1968. This action is filed on behalf of all the stockholders, and the Court is of the opinion that under the facts here averred a "seller" within the purview of the Act need not be one who has actually made a sale of his personal stock. **Hooper v. Mountain States Securities Corporation**, 282 F. 2d 195 (5 Cir.), cert. denied 365 U. S. 814; **Ruckle v. Roto American Corporation**, 339 F. 2d 24 (2 Cir.); **Vine**

v. Beneficial Finance Co., 374 F. 2d 627 (2 Cir.); and **Dasho v. Susquehanna Corporation**, 380 F. 2d 262, cert. denied sub nom **Bard v. Dasho**, 88 S. Ct. 480.

In view of the decisions last referred to, and the broad sweep of **J. I. Case Co. v. Borak**, 377 U. S. 426, and **Surowitz v. Hilton Hotels Corporation**, 383 U. S. 363, the Court is unable to say that it appears beyond doubt that plaintiffs can prove no set of facts in support of their claim which would entitle them to relief. **Conley v. Gibson**, 355 U. S. 41, 45. The motions will be considered as directed to the complaint as amended on October 1, 1968.

It is, therefore, Ordered, Adjudged and Decreed that the motions of Claude E. Shell, L. E. Cowling, Jack E. Love, Robert H. Wallace, National Securities, Inc., Old National Life Insurance Company and Alabama National Life Insurance Company, to dismiss, including defendant Cowling's motion to quash, be and each of same is hereby overruled. Defendants are granted thirty days in which to file their answers to the complaint as amended.

Done and Ordered, this the 15th day of October, 1968.

.....

United States District Judge

APPENDIX VIII

In the United States District Court for the Northern District of Alabama, Southern Division

Milford E. Hensley et al., Plaintiffs		
vs.		Civil Action No. 69-35
Jack E. Love et al., Defendants		

Order

(Filed March 12, 1969)

This matter came on to be heard on various motions filed on behalf of defendant Robert E. Wilder and on behalf of all other defendants in this action, except Claude Shell, L. E. Cowling, R. L. Cowling, R. E. Cowling, Mrs. Strube, and the Cowling Family Trust. After hearing oral argument thereon, and being advised in the premises, the Court hereby Orders, Adjudges and Decrees as follows:

1. The motion of defendant Wilder to dismiss is hereby denied.

2. The motions filed by the other defendants, with the exception of Shell and the Cowlings, to dismiss are based principally upon the argument that deceit is requisite to the maintenance of a Rule 10(b)5 action, and that the complaint fails to allege sufficiently the requisite deceit, under the authority of **O'Neill v. Maytag**, 339 F. 2d 764, 767-68 (2d Cir. 1964), and **Birnbaum v. Newport Steel Corp.**, 193 F. 2d 461, 463-64 (2d Cir. 1952). However, in view of the reach of the decision in **SEC v. Capital Gains Research**

Bureau, Inc., 375 U. S. 180 (1963), construing "fraud or deceit" as employed in the Investment Advisers Act of 1940, and the recent en banc decision of the United States Court of Appeals for the Second Circuit in **Schoenbaum v. Firstbrook**, CCH Fed. Sec. L. Rep., par. 92, 327 (Dec. 30, 1968), the averments in the particular challenged are sufficient. See also, **Ruckle v. Roto American Corp.**, 339 F. 2d 24, 29 (2d Cir. 1964); **Hooper v. Mountain States Sec. Corp.**, 282 F. 2d 195 (5th Cir. 1960), cert denied, 365 U. S. 814 (1961).

3. Defendants' motions to dismiss are each denied and said defendants will answer the complaint within twenty days.

4. The defendants' motions to quash the deposition of Jack E. Love and to abate further proceedings in this cause are each hereby denied.

All other motions filed herein will be heard at the next regular motion docket.

Done and Ordered, this the 12th day of March, 1969.

H. H. Grooms
United States District Judge

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1970

No. 1078

EDWIN J. HERPICH, on Behalf of All the Stockholders of NATIONAL AMERICAN LIFE INSURANCE COMPANY,

Petitioner

versus

ROBERT E. WILDER and NATIONAL AMERICAN LIFE INSURANCE COMPANY, a Louisiana Corporation,

Respondents

BRIEF IN OPPOSITION TO PETITION FOR A WRIT OF CERTIORARI

to the United States Court of Appeals for the Fifth Circuit

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1970

No. 1078

EDWIN J. HERPICH, on Behalf of All the Stockholders of NATIONAL AMERICAN LIFE INSURANCE COMPANY,

Petitioner

versus

ROBERT E. WILDER and NATIONAL AMERICAN LIFE INSURANCE COMPANY, a Louisiana Corporation,

Respondents

BRIEF IN OPPOSITION TO PETITION FOR A WRIT OF CERTIORARI

to the United States Court of Appeals for the Fifth Circuit

OPINIONS BELOW

The opinion of the Court of Appeals for the Fifth Circuit in this case, in which review is sought, appears in the advance sheets for November 9, 1970, 430 F. 2d 818. The companion case of **Herpich v. Wallace**, as to which no review was sought, appears in the advance sheets, 430 F. 2d 792-818. The case of **Shell v. Hensley**, to which neither Respondent Wilder nor Respondent National American was a party, but which did include as Defendants, the individuals named in **Herpich v. Wallace**, 430 F. 2d 792, is reported at 430 F. 2d 819-827.

QUESTIONS PRESENTED

1. Does the Securities Exchange Act of 1934 [15 USC 78j(b)] and Rule 10b-5 make illegal the previously recognized right of the holder of "control" stock to derive a premium above the general market price?

2. Does each individual holder of shares of a corporation, who does not engage in any securities transaction, have a right of action under Rule 10b-5 against the president of the corporation, based solely upon the fact that he made a private sale of his privately owned stock without forcing the purchaser to offer the same purchase price to every other individual holder of shares in that corporation?

STATEMENT OF THE CASE

Prior to January 24, 1968, Respondent Wilder owned 6.32 per cent of the stock of National American Life Insurance Company. He also owned 55.39 per cent of the stock of the holding company, First Colonial Corp. of America, which itself owned 26.81 per cent of the stock of National American. Wilder, therefore, controlled directly or indirectly a total of 33.13 per cent of the stock of National American. Wilder was president and director of both National American and First Colonial. (Complaint, Para. 2, Appendix I, infra, p. 16).

In a privately negotiated sale as to which there is no charge of misrepresentation or failure to disclose, Wilder sold this controlling bloc of stock to National Securities, Inc. for Five Million Dollars, which was allegedly Three Million Dollars in excess of the then market value of the stock. 430 F. 2d at 798. The

purchasers are apparently well satisfied with their purchase.

However, Petitioner Herpich, who in 1955 purchased his stock in National American, instituted suit against both the seller, Wilder, and the purchaser, National Securities, Inc., and its controlling officers, Robert Wallace and his "Arizona Group". The suit against the seller, Respondent Wilder, was filed in the Middle District of Alabama, and that against the purchaser was filed in the Eastern District of Louisiana. Both actions purported to be derivative actions on behalf of the corporation, National American, and, also, on behalf of Herpich, individually, and all other individual shareholders of National American.

The District Judge, in each case, granted Motion to Dismiss. On appeal, both cases were affirmed in part and reversed in part. **Herpich v. Wilder**, 430 F. 2d 818-9; **Herpich v. Wallace**, 430 F. 2d 792-817.

In both cases, the Court of Appeals held that the Complaint stated no cause of action under the Investment Company Act. Petition for Certiorari does not question the correctness of this ruling. In both cases, the Court of Appeals affirmed the dismissal of the Count based upon a loan to the accountant, Latta, and again no question is raised as to the correctness of that ruling.

As to the other two Counts in both Complaints, the Court of Appeals held that the District Court erred in granting the Motion to Dismiss and that the actions could be maintained as a derivative action on behalf of the Corporation, National American, which was alleged to have been defrauded in that it would

be required to pay a part of the allegedly excessive purchase price for Wilder's stock.

In the opinion in **Herpich v. Wallace**, 430 F. 2d 792, the Court of Appeals considered at great length the purpose and objects of the Securities Acts and Rule 10b-5. Following the reasoning of the Eighth Circuit and the Second Circuit, the Court of Appeals adopted for the Fifth Circuit the rule that only purchasers and sellers of securities involved in an alleged 10b violation can show injury of the type the rule is meant to prevent. Since the Plaintiffs, individually, and other individual shareholders, were neither purchasers nor sellers of securities, the Court held that Plaintiffs were not entitled to bring an action under Rule 10b-5 on behalf of themselves or their class. **Herpich v. Wallace**, 430 F. 2d 792, at 803.

The Petitioner in this case was the party Appellant in **Herpich v. Wallace** and did not seek to review the decision of the Court of Appeals in that case.

The Opinion here sought to be reviewed is less than two pages long. It sets forth no new rule of law, but only:

> "Therefore, for the reasons set forth in our opinion in the Wallace case, we hold that the judgment appealed from must be reversed in part."

We are, therefore, faced with the anomaly that Petitioner Herpich asks this Honorable Court to review and revise the judgment of the Court of Appeals, which merely applied to the facts of this case the principles of law announced by the same court in

another case to which Herpich was a party, the correctness of which Herpich did not question by Petition for Certiorari.

SUMMARY OF THE ARGUMENT

I

Normally a controlling shareholder has the right to derive a premium from the sale of controlling bloc of stock.

Essex Universal Corp. v. Yates, 305 F. 2d 574, 576.

Levy v. American Beverage Corp., 265 App. Div. 208, 218, 38 NYS 2d 517, 526.

Stanton v. Schenck, 140 MISC. 621, 251 NYS 221.

Honigman v. Green Giant Co., 208 F. Supp. 754, Aff. 309 F. 2d 667, CD. 372 US 941 (1963).

Dasho v. Susquehanna Corp., (ND. Ill.), Feb. 6, 1970, CCH, Federal Securities Law Reporter, p. 98, 607, at 98,624.

Goode v. Powers, 97 Ariz. 75, 397 Pac. 2d 56.

a. In Alabama any restriction on the right of a shareholder to transfer his shares must be construed strictly and may be in contravention of public policy as an illegal restraint upon transfer.

Security Life & Accident Ins. Co. v. Carlovitz, 251 Ala. 508, 511; 38 So. 2d 274.

II

In the passage of the various Securities Acts it was not the intent of Congress to establish a "Uniform Federal Law of Corporations", to preempt to

the Securities and Exchange Commission the regulation of relationship between corporate officers and shareholders, or to give each individual shareholder a right of action against a controlling shareholder who does what is otherwise legal, that is, sell his privately owned shares at private sale, free of misrepresentation or failure to disclose, at a price satisfactory to the purchaser.

ARGUMENT

At the outset, we face the fact that the principles of law of which Petitioner complains were not announced by the Court of Appeals in this case, but in another case, **Herpich v. Wallace**, to which Petitioner was a party, but which Petitioner did not seek to review. The quotations in the Petition, p. 5, and on p. 14, are quotations from the **Wallace** opinion, not the opinion in this case. In effect, therefore, Petitioner is seeking to review the action of the Court of Appeals in applying to the facts in this case, the principles of law announced by the same Court of Appeals in another case, which was not reviewed. That hardly comes within the scope of Rule 19 (1-b).

Secondly, there is grave doubt as to whether the issue now sought to be raised was raised before the Court of Appeals. In the Statement of Issues Presented for Review, filed in that Court, (Appendix II hereto, p. 31), no effort was made to raise the issue of the rights of the individual shareholders separate and apart from that of the corporation suing derivatively. Issue Number One specifically pointed out that part of the purchase price was paid by the corporation, National American, and charges that "Wilder never accounted and never intended to ac-

count to, National American Life Insurance Company or to its stockholders for said premium". The Court of Appeals upheld the right of the corporation, National American Life Insurance Company, to proceed under Rule 10b-5.

Entirely aside from those preliminary questions, we respectfully submit that the principles of law announced by the Court of Appeals were entirely correct and that the ruling sought by Petitioner would do violence to both the letter and spirit of the Securities Acts and would wreak havoc with the Securities markets which Congress sought to protect.

I

It is not illegal for a controlling shareholder to derive a premium from the sale of controlling bloc of stock.

Unless rendered illegal by the Securities Exchange Act of 1934, the right of a controlling shareholder to derive a premium from the sale of a controlling bloc of stock has been generally upheld by the Courts. **Essex Universal Corp. v. Yates**, 305 F. 2d 572, at 576, and cases cited; **Honigman v. Green Giant Co.**, 208 F. Supp, 754, Aff. 309 F. 2d 667, Cert. Denied 372 US 941 (1963).

Although Professor A. A. Berle advanced the view that control is a corporate asset, this issue is not raised on this Petition since there is involved here only the question of the right of minority stockholders to require the controlling shareholder to account, not to the corporation, but to each other individual shareholder.

In Alabama restrictions on the right of a shareholder to transfer his shares are construed strictly

and may be held violative of public policy. **Security Life & Accident Ins. Co. v. Carlovitz**, 251 Ala. 508, 511; 38 So. 2d 274.

II

Congress did not intend to preempt from State regulation, all relationships between officers, controlling shareholders, and other individual shareholders.

Petition cites on page 8, an article written by Petitioner's Attorney in 21 Ala. Law Review 457, in which he treats Rule 10b-5 as "another step in the continuing development of Federal Corporation Law". It is his theory that Congress intended the Securities Exchange Act and Rule 10b-5 to establish a full blown Federal Law of Corporations. In view of the exclusive jurisdiction provision of Section 27 of the Act and the principle of preemption, this position, if followed, would take away all rights of State legislatures and State courts to regulate the relationship of officers and directors and controlling persons of domestic corporations, to all other holders of shares of that corporation.

This is far removed from the congressional intent to regulate the sale of securities itself; for the individual shareholders on whose behalf this Petition is filed did not participate in any purchase or sale of securities in question.

Congress did expressly regulate the purchase and sale of securities by insiders in Section 16b of the Exchange Act [15 USC 78p(b)]. Even in that case, however, the liability of the insider is not to the individual shareholder, but to the corporation itself. This specific provision as to sales by controlling

shareholders negatives the conclusion that the broad language of Section 10 and Rule 10b-5 were intended to prohibit sales of control at private sale which otherwise would be legal and proper.

There have been many expressions in this Court and Courts of Appeals as to the purpose and objectives of the Securities Act. In **SEC v. Capital Gains Research Bureau**, 375 US 180, 186; 84 S. Ct. 275, 280; 11 L. ed 2d 237, this Court stated that a fundamental purpose of the act was "to substitute a philosophy of full disclosure for the philosophy of caveat emptor".

The Court of Appeals for the Fifth Circuit states:

> "By Section 10b Congress meant to prevent manipulation and control of the prices at which securities are bought and sold and to enable buyers, sellers, and traders of securities to make a proper appraisal of the value of securities. Securities Exchange Act of 1934, Sec. 2(3), 15 USC, Sec. 78b(3). See also Hearings on Stock Exchange Regulation Before the House Comm. on Interstate and Foreign Commerce, 73d Cong., 2d Sess. (1934); Ruder, Civil Liability Under Rule 10b-5, Judicial Revision of Legislative Intent?, 57 Nw. U. L. Rev. 627, 657 (1963)." **Herpich v. Wallace**, 430 F. 2d 792, at 801.

In **Securities and Exchange Commission v. Texas Gulf Sulphur Co.**, 401 F. 2d 833, at 860, the Court of Appeals for the Second Circuit, said:

> "[29, 30] Therefore it seems clear from the legislative purpose Congress expressed in the Act, and the legislative history of Section 10 (b) that Congress when it used the phrase 'in con-

nection with the purchase or sale of any security' intended only that the device employed, whatever it might be, be of a sort that would cause reasonable investors to rely thereon, and, in connection therewith, so relying, cause them to purchase or sell a corporation's securities."

Again, in **Herpich v. Wallace**, 430 F. 2d at 806:

"In short Congress meant to afford investors a reasonable opportunity to make knowing intelligent decisions regarding their purchases and sales of securities in unmanipulative markets, see Kahan v. Rosenstiel, 3 Cir., 1970, 424 F. 2d 161, 173, and the loss resulting in connection with purchases or sales made without benefit of such an opportunity is the type of injury section 10(b) and Rule 10b-5 seek to prevent. See Mutual Shares Corporation v. Genesco, Inc., 2 Cir., 1967, 384 F. 2d 540, 546. See also Britt v. Cyril Bath Company, 6 Cir., 1969, 417 F. 2d 433, 435."

The requirement of full disclosure; enabling buyers and sellers to make a proper appraisal of the value of securities; the prevention of devices which would cause reasonable investors to rely thereon and in connection therewith so relying, cause them to purchase or sell securities; and the affording of investors a reasonable opportunity to make knowing intelligent decisions regarding their purchases and sales of securities, fall far short of establishing a Congressional intent to prohibit the sale of securities at private sale, without misrepresentation or concealment, at a price satisfactory to the purchaser. Petition cites no authority to sustain the position that Congress intended to give a new federal cause of

action to every holder of shares of a corporation, who was in no way misled, who in no way participated in the purchase or sale of securities, because the president, in selling his privately owned stock, did not force the purchaser to make a similar offer to all other shareholders.

III

The Court should consider economic reality and the effect upon securities markets and corporate affairs.

In three cases, this Court has referred to the necessity of looking at the economic reality of the transaction. **US v. Phosphate Export Assn.**, 393 U. S. 199, 208; 21 L. ed 2d 344, 351; 89 S. Ct. 361; **Tcherepnin v. Knight**, 389 U. S. 332, 336; 19 L. ed 2d 564, 569, 89 S. Ct. 548; **SEC v. W. J. Howey Co.**, 328 U. S. 293, 298; 90 L. ed 1244, 1249, 66 S. Ct. 1100; 163 ALR 1043.

On page 12 of Petition, reference is made to the Brief for SEC as amicus curiae in the case of **Pacific Insurance Co. v. Blot**, 267 F. Supp. 956. On page 9 of that Brief, Counsel for the Commission cautioned against a ruling that would be "unnecessarily drastic and potentially unsettling for the securities markets and corporate affairs".

We can think of few rulings which would be more disastrous to the securities markets, than a ruling which would vest in every individual shareholder an individual right of action against every seller of a bloc of stock which might be characterized as "control". We are not here concerned with sales of stock quoted on National Securities Exchanges.

Thousands of corporations have stock unlisted on any exchange and seldom traded on the over-the-counter market. In case of a "thin" market, the bid and ask price would give no indication of the true investment value of the securities in question.

In such a case, [and such a case arises everyday], the offer of a substantial bloc on the open market would result in the very disruption of orderly trading which Congress sought to prevent. The economic loss would not only be suffered by the person who offered a substantial bloc, it would be shared by every other seller on such depressed market.

A similar situation would develop if the prospective purchaser sought to acquire a substantial bloc on the open market rather than by private negotiated sale. Again, there would be a disruption of orderly trading and a distortion of the price of securities.

If there is a duty on the seller of a controlling bloc of stock to obtain the same price for every other shareholder, the action of the purchaser in purchasing at private sale could be characterized as inducing a breach of duty and both seller and purchaser would be liable to suit by every other individual shareholder. Such issues as to whether there was an actual premium paid, and whether the bloc of stock actually represented "control" would probably be left for the decision of the jury in each individual case. Not only would past transactions be subject to litigation, prospective purchasers and sellers of more than a nominal amount of stock would be prevented or at least deterred from the ordinary private negotiations which are recognized as legal in the cases cited above.

A purchaser could not safely purchase unlisted stock from the owner thereof without a thorough investigation to determine whether such shares, even though substantially less than 50 per cent, could conceivably be characterized as "control" stock; and the owner of any such bloc would be restrained from taking advantage of a voluntary offer of a price satisfactory to both purchaser and seller.

Such a solution might be Paradise for securities attorneys but would be Hades for the investors involved. We respectfully submit that Congress did not intend the type of chaos which would result from such a ruling.

IV

The Petition in Docket No. 1159, Superintendent of Insurance as liquidator for Manhattan Casualty Company vs. Bankers Life & Casualty Company is immaterial in this case.

Petitioner seeks to bolster its case here by reference to Petition for Certiorari Docketed under No. 1159, to review the decision of the Court of Appeals for the 2nd Circuit in **Superintendent of Insurance as liquidator for Manhattan Casualty Company vs. Bankers Life & Casualty Company**, 430 Fed. 2nd 355.

We submit that the lack of merit in the instant case is not remedied by the possible merit in Docket No. 1159 and the instant Petition should be denied because of its own lack of merit.

We further submit that the issue raised in that case is in no way related to the issue here presented.

In this case individual shareholders seek to hold the seller of "control", responsible to them individually, not to the corporation. In this case there was no depletion of the funds of the corporation or of the Plaintiffs individually. In this case the only alleged crime was that Respondent, Wilder, sold his privately owned stock at private sale without misrepresentation or concealment, to a private purchaser who is satisfied with his purchase.

While the Bankers Life case does involve a sale of control, the claim for damages was strictly on behalf of the corporation to recover, not any alleged premium above market price, but $5,000,000.00 of assets of the corporation which were taken from the corporation's treasury. That case is typical of those involving looting; a sale of corporate control to people who intended to loot the company. No such issue is involved in this case.

CONCLUSION

For the above reasons, we respectfully submit that the Petition for Writ of Certiorari should be denied.

JACK CRENSHAW
Attorney for Respondent,
Robert E. Wilder

Of Counsel

CRENSHAW AND WALLER
Suite 206 Washington Building
Montgomery, Alabama 36104

APPENDIX I

IN THE UNITED STATES DISTRICT COURT FOR THE MIDDLE DISTRICT OF ALABAMA NORTHERN DIVISION

EDWIN J. HERPICH, on behalf of Himself and all other stockholders (other than defendant Wilder and persons in conspiracy with him) of National American Life Insurance Company, Plaintiff vs. ROBERT E. WILDER; and NATIONAL AMERICAN LIFE INSURANCE COMPANY, a Louisiana corporation, Defendants	CIVIL ACTION No. 2747-N

AMENDED COMPLAINT

Pursuant to leave of Court granted by this Court's Order of October 24, 1968 herein, plaintiff, acting by his attorneys, hereby amends his Complaint herein to read as follows:

I.

Plaintiff

Plaintiff EDWIN J. HERPICH is a resident citizen of Louisiana. Plaintiff HERPICH is now and has continuously since, to-wit, 1955 been the owner of, to-wit, 1,000 shares of common stock of NATIONAL AMERICAN LIFE INSURANCE COMPANY.

II.

Defendants

1. Defendant NATIONAL AMERICAN LIFE INSURANCE COMPANY is a Louisiana corporation qualified to do business and doing business in Alabama. Its home office is now, and its principal office and place of business until at least, to-wit, February, 1968 was, in Baton Rouge, Louisiana. On information and belief, its executive offices are now in Phoenix, Arizona.

2. Defendant ROBERT E. WILDER is on information and belief a resident citizen of Montgomery, Alabama and is over the age of twenty-one years. At all times relevant between, to-wit, the incorporation of NATIONAL AMERICAN LIFE INSURANCE COMPANY in, to-wit, 1955 and, to-wit, February 14, 1968, defendant WILDER was president, chairman of the board of directors, a director, and a "controlling person" of NATIONAL AMERICAN LIFE INSURANCE COMPANY and of First Colonial Corp. of America within the meaning of the Securities Act of 1933, the Securities Exchange Act of 1934, and the Securities Act of Alabama.

III.

Jurisdiction and Venue

This Court has jurisdiction of so much of this action as is based upon violations of the federal securities acts pursuant to the provisions of Section 27 of the Securities Exchange Act of 1934 (15 U. S. C. §78aa), Section 22 of the Securities Act of 1933 (15 U. S. C. §77v), Section 44 of the Investment Company Act of 1940, and 28 U. S. C. §1377, and this

Court has pendant jurisdiction of so much of this action as is based upon state law pursuant to the principles of law enunciated by the United States Supreme Court in **Hurn v. Oursler**, 289 U. S. 238, and **United Mine Workers of America v. Gibbs**, 89 S. Ct. 1130.

2. On information and belief, venue is properly laid in this district because defendant WILDER is present and resides in this district; because defendant NATIONAL AMERICAN LIFE INSURANCE COMPANY transacts business, is qualified to transact business, and has consented to service upon it by service upon the Superintendent of Insurance of the State of Alabama in this district; and because acts were performed in this district in furtherance of the conspiracy and wrongs complained of herein.

IV.

Facts Upon Which This Complaint is Based

Each of the following allegations is made on information and belief:

COUNT ONE

1. At all times relevant to this action prior to, to-wit, January 24, 1968 defendant WILDER personally owned, to-wit, 6.32% of the issued and outstanding common capital stock of defendant NATIONAL AMERICAN LIFE INSURANCE COMPANY.

2. At all times relevant prior to, to-wit, January 24, 1968, defendant WILDER owned, to-wit, 55.39% of the issued and outstanding common capital stock of First Colonial Corp. of America.

3. At all times relevant prior to, to-wit, January 24, 1968, First Colonial Corp. of America owned, to-wit, 26.81% of the issued and outstanding common capital stock of and controlled defendant NATIONAL AMERICAN LIFE INSURANCE COMPANY.

4. At all times relevant prior to, to-wit, January 24, 1968, defendant WILDER was President and Director of and controlled First Colonial Corp. of America and NATIONAL AMERICAN LIFE INSURANCE COMPANY.

5. At all times relevant, First Colonial Corp. of America was, and held itself out to the public as being, an "investment company" as defined by the Investment Company Act of 1940, as defendant WILDER at all times relevant well knew.

6. Defendant WILDER caused First Colonial Corp. of America to omit to register and qualify as an investment company with the SEC, although required by law to so register and qualify.

7. Defendant Wilder, by the use of the mails and means and instrumentalities of interstate commerce, caused NATIONAL AMERICAN LIFE INSURANCE COMPANY to do the following:

(a) To lend First Colonial Corp. of America on no security or on grossly inadequate security various sums totalling in excess of One Million Dollars.

(b) To misrepresent and conceal said loans by filing convention reports with state insurance officials which reported the amount owed it by First Colonial Corp. of America as an asset, although

said debt was not fully secured and not due to be so reported.

(c) To guarantee various obligations of First Colonial Corp. of America.

(d) To engage with First Colonial in various purchases and sales of securities.

(e) To pay and lend WILDER various sums of money.

8. Defendant WILDER by the use of the mails and means and instrumentalities of interstate commerce caused First Colonial Corp. to engage in interstate commerce, to borrow and lend money, and to purchase and sell securities, all in violation of the Investment Company Act of 1940.

9. As a result of said illegal transaction, the assets of NATIONAL AMERICAN LIFE INSURANCE COMPANY (including its unsecured advances to First Colonial Corp. of America) were depleted and wasted, all to its detriment and to the detriment of plaintiff and similarly situated stockholders of NATIONAL AMERICAN LIFE INSURANCE COMPANY, and the value of stock of NATIONAL AMERICAN LIFE INSURANCE COMPANY owned by plaintiff and similarly situated stockholders has been diminished, all to the damage of plaintiff and similarly situated stockholders in the amount of, to-wit, Five Million Dollars ($5,000,000.00).

COUNT TWO

1. At some time on or about November 29, 1967 Robert H. Wallace, Jack E. Love, ROBERT E. WILDER, National Securities, Inc. and Old National Life

Insurance Company conspired to cause National Securities, Inc. to purchase certain shares of stock from defendant WILDER at a price higher than their then market value, to be paid in part by NATIONAL AMERICAN LIFE INSURANCE COMPANY stockholder, although legally obligated to do so, to cause WILDER to be issued an option to buy shares of Capitol National Bank of Montgomery, Alabama, and to defraud NATIONAL AMERICAN LIFE INSURANCE COMPANY, plaintiff and similarly situated stockholders of NATIONAL AMERICAN LIFE INSURANCE COMPANY.

2. Pursuant to and in furtherance of said conspiracy, and by the use of the mails and means and instrumentalities of interstate commerce, the conspirators did or caused to be done the following:

(a) National Securities, Inc. executed an agreement to purchase from WILDER his shares of capital stock of NATIONAL AMERICAN LIFE INSURANCE COMPANY and First Colonial Corp. of America, which owned a substantial number of issued and outstanding shares of capital stock of NATIONAL AMERICAN LIFE INSURANCE COMPANY.

(b) National Securities, Inc. agreed to and did, in fact, pay ROBERT E. WILDER more than the then market value of his shares of said stock in order to obtain control of NATIONAL AMERICAN LIFE INSURANCE COMPANY and its assets.

(c) As part of the agreement whereby WILDER agreed to sell said shares to National Securities, Inc., he agreed to resign as President, Director and Chairman of the Board of NATIONAL

AMERICAN LIFE INSURANCE COMPANY and to assist in electing Wallace and his associates to become officers and directors of NATIONAL AMERICAN LIFE INSURANCE COMPANY and its assets.

(d) National Securities, Inc. agreed to pay a premium for WILDER'S said shares in order to acquire control of NATIONAL AMERICAN LIFE INSURANCE COMPANY and its assets, for the purpose of enabling Wallace, National Securities, Inc., and Love to manipulate, transfer, and dispose of the assets of NATIONAL AMERICAN LIFE INSURANCE COMPANY in their own interests and without regard to and contrary to interests of NATIONAL AMERICAN LIFE INSURANCE COMPANY and all of its stockholders.

(e) The conspirators caused NATIONAL AMERICAN LIFE INSURANCE COMPANY and First Colonial Corp. of America to enter into an agreement dated on or about November 29, 1967 with Federated Investments, Inc. whereby First Colonial Corp. of America (which then was insolvent) agreed to purchase 43,200 shares of stock of Capitol National Bank of America for $1,188,000.00, and whereby NATIONAL AMERICAN LIFE INSURANCE COMPANY guaranteed the obligations of First Colonial Corp. of America.

(f) The conspirators then caused National Securities, Inc. on January 24, 1968 to grant defendant WILDER an option to purchase said 43,200 shares, representing 54% of the outstanding shares of stock of Capitol National Bank of Montgomery, Alabama.

(g) Said option was a "security" within the meaning of all applicable federal securities laws.

(h) Said option was granted to WILDER, in connection with the purchase of and as part of the purchase price paid by National Securities, Inc. for WILDER's shares of NATIONAL AMERICAN LIFE INSURANCE COMPANY stock and First Colonial Corp. of America stock.

(i) Said transaction, and the granting of said option to WILDER operated as a fraud upon NATIONAL AMERICAN LIFE INSURANCE COMPANY, plaintiff and similarly situated stockholders of NATIONAL AMERICAN LIFE INSURANCE COMPANY.

(j) National Securities, Inc. agreed to pay defendant, WILDER, in excess of, to-wit, Five Million Dollars for his said shares, said purchase price to be paid in part by NATIONAL AMERICAN LIFE INSURANCE COMPANY, in fraud on plaintiff and all similarly situated stockholders.

(k) No similar offer was made to plaintiff and other stockholders, although WILDER was obligated by law to ensure that the sale of "control" of assets of NATIONAL AMERICAN LIFE INSURANCE COMPANY or of the company not be cast in a manner advantageous only to WILDER.

3. By reason of casting the transaction with National Securities, Inc. as a sale by WILDER of his stock, rather than as a sale of assets by the company, WILDER instead of the company was paid and realized a "premium" in the amount of, to-wit, Five Million Dollars ($5,000,000.00) for control of the

assets and of the company, over and above the market value of his shares.

4. WILDER is legally obligated to account of NATIONAL AMERICAN LIFE INSURANCE COMPANY, plaintiff and all similarly situated stockholders for said premium.

5. WILDER was legally obligated to plaintiff and other similarly situated stockholders of NATIONAL AMERICAN LIFE INSURANCE COMPANY to ensure that the same offer on the same terms be made **pro rata** to all stockholders, but he did not do so.

6. Plaintiff and similarly situated stockholders have been damaged in the amount of, to-wit, Five Million Dollars by reason of facts averred in this Count Two.

COUNT THREE

1. On or about February 24, 1967, WILDER, in connection with a sale of securities by L. D. Harris to NATIONAL AMERICAN LIFE INSURANCE COMPANY, and by the use of the mails and means and instrumentalities of interstate commerce, employed devices, artifices and schemes to defraud, and engaged in a course of business dealings which operated as a fraud upon NATIONAL AMERICAN LIFE INSURANCE COMPANY, plaintiff and similarly situated stockholders.

2. On, to-wit, February 24, 1967 NATIONAL AMERICAN LIFE INSURANCE COMPANY paid Luther D. Harris, then one of its directors, $100,000.00 under the pretext, device and contrivance of making a "loan" to Harris and agreed to accept 12,947 shares of the common stock of First Colonial

Corporation of America, pledged as security for said "loan", as payment in full of said loan in the event said "loan" was not paid when due, and NATIONAL AMERICAN LIFE INSURANCE COMPANY agreed that it would not assert a deficiency against Harris, irrespective of the value of said shares at the time of default in said loan.

3. Said transaction constitutes a fraud on NATIONAL AMERICAN LIFE INSURANCE COMPANY and its stockholders in that the effect of the transaction is that, if the stock appreciates, Harris can pay off the loan and keep the stock, but in the event the stock is worth less than $100,000.00, NATIONAL AMERICAN LIFE INSURANCE COMPANY will have to purchase, to-wit, 12,947 shares of common stock of its parent for the price of, to-wit, $100,000.00, which at all relevant times has been and now is more than said shares' market value.

4. In connection with and as part of the February 24, 1967 transaction, NATIONAL AMERICAN LIFE INSURANCE COMPANY also guaranteed a loan of, to-wit, $200,000.00 made to L. D. Harris and Sons, d/b/a Express Transfer Company, a partnership, and lent money to L. D. Harris secured by a deed of trust on his home in Dallas, Texas.

5. Said transaction damaged and defrauded NATIONAL AMERICAN LIFE INSURANCE COMPANY and its stockholders in the amount of, to-wit, One Hundred Thousand Dollars ($100,000.00).

COUNT FOUR

1. On or about April 18, 1967, by the use of the mails and means and instrumentalities of interstate

commerce, defendant WILDER employed devices and artifices to defraud and engaged in transactions and a course of dealing which operated a fraud upon NATIONAL AMERICAN LIFE INSURANCE COMPANY and its stockholders, in that on, to-wit, April 18, 1967, WILDER caused NATIONAL AMERICAN LIFE INSURANCE COMPANY to arrange to have $100,000.00 paid Raymond A. Latta by the device, artifice and strategem of guaranteeing a "loan" of, to-wit, $100,000.00 to defendant Raymond A. Latta, to finance Latta's purchase of 20% of the issued and outstanding stock of Dawl Corporation, a Louisiana corporation, owned in part by WILDER, the principal assets of Dawl being an undeveloped tract of land south of Baton Rouge, Louisiana, which stock was on or about July 1, 1967 was then exchanged for stock of First Colonial Life Insurance Company.

2. The First Colonial Life stock was then pledged as security for the loan.

3. Said First Colonial Life stock is not worth the amount owed on the loan.

4. In connection with the purchase of said shares of Dawl stock, on, to-wit, May 15, 1967, NATIONAL AMERICAN LIFE INSURANCE COMPANY agreed to pay Mr. Latta $45,000.00 **plus** additional compensation for any actual work he might do.

5. First Colonial Life Insurance Company has been damaged and defrauded in the amount of, to-wit, One Hundred Fifty Thousand Dollars ($150,000.00) by reason of the facts alleged in this Count.

V.

Allegations Supporting Maintenance of This Suit As A Class Action

Each of the following allegations is made on information and belief:

1. This action is brought on behalf of all stockholders of NATIONAL AMERICAN LIFE INSURANCE COMPANY.

2. There are more than, to-wit, 12,000 members of said class, so that joinder of all members of the class is impracticable.

3. This is not a collusive action to confer jurisdiction on this Court which it would not otherwise have.

4. There are common questions of law or fact common to such class, including, but not limited to, the following:

(a) Whether defendant WILDER received a premium for "control" of, and his stock in, NATIONAL AMERICAN LIFE INSURANCE COMPANY, and in First Colonial Corporation of Delaware, at a time when he owed fiduciary duties to NATIONAL AMERICAN LIFE INSURANCE COMPANY and to plaintiff and similarly situated stockholders;

(b) Whether WILDER is due to account to NATIONAL AMERICAN L I F E INSURANCE COMPANY for said premium;

(c) Whether WILDER was legally obligated to have the same offer made pro rata to all stockholders;

(d) Whether defendant WILDER sold stock representing "control" of NATIONAL AMERICAN LIFE INSURANCE COMPANY at a premium, without making the same terms available to other stockholders, to whom he then owed a fiduciary duty not to sell his stock without making the same opportunity and offer available to them;

(e) Whether defendant WILDER caused NATIONAL AMERICAN LIFE INSURANCE COMPANY to lend money to First Colonial Corp. of America and engage in other transactions with First Colonial Corp. of America in violation of the Investment Company Act of 1940, state law, and the Securities Exchange Act of 1931;

(f) Whether WILDER is liable to NATIONAL AMERICAN LIFE INSURANCE COMPANY for the acts hereinabove alleged.

5. Prior to filing hereof, demand was not made on the Board of Directors or stockholders of NATIONAL AMERICAN LIFE INSURANCE COMPANY that they file suit on behalf of that corporation for the wrongs complained of herein, and such demand would be futile and unavailing because, on information and belief;

(a) The above alleged facts have been known by a majority of the said directors since, to-wit, February 1968, but no corrective legal action pertaining thereto has been taken or proposed.

(b) A majority of said directors are controlled or dominated by defendant WILDER or by persons who conspired with him in doing the wrongs hereinabove alleged.

(c) A majority of said directors have not heretofore and would not now take any action against WILDER because to do so might expose them to personal liability for negligence or for aiding and abetting WILDER.

(d) There are more than 12,000 stockholders of NATIONAL AMERICAN LIFE INSURANCE COMPANY and it would be unduly expensive and burdensome to require plaintiff to make prior demand on them and to fully explain the situation.

(e) The wrongs complained of cannot be ratified by stockholders without unanimous consent.

(f) Applicable law does not require such demand.

6. The claims of plaintiff are typical of the claims of the entire class.

7. The plaintiff will fairly and adequately protect the interests of the entire class.

8. The acts of defendant WILDER alleged in this Complaint are wrongs against each member of the class sued for herein, on grounds generally applicable to said class and each member thereof, making appropriate declaratory relief with respect to the class sued for as a whole.

9. The questions of law and fact common to the members of the class sued for herein predominate over any questions affecting only individual members.

10. Permitting a class action herein is and will be superior to other available methods for the adjudication of controversies and claims set out herein between members of the class sued for and the defendants herein.

VI.

Discovery of Facts Alleged Herein

Plaintiff did not discover the wrongful acts alleged herein prior to, to-wit, February 14, 1968, nor could he have discovered the same by the exercise of any duty imposed on him (if any existed) because of the concealment and misrepresentation of said facts by defendant WILDER which misrepresentations and omissions were in part for the purpose of lulling and deceiving plaintiff and members of his class, and preventing them from discovering the fraud and deceit practiced upon them.

VII.

Demand for Judgment

1. Plaintiff, on behalf of all stockholders of NATIONAL AMERICAN LIFE INSURANCE COMPANY, hereby demands judgment against defendant WILDER, for the use and benefit of NATIONAL AMERICAN LIFE INSURANCE COMPANY and all its stockholders, in the amount of $5,000,000.00.

2. Plaintiff prays that the option granted WILDER to buy Capitol National Bank stock be declared null and void.

3. Plaintiff prays for such other, further and different relief to which he may be entitled, the premises considered.

BERKOWITZ, LEFKOVITS,
VANN & PATRICK
1400 City National Bank Building
Birmingham, Alabama 35203
Attorneys for Plaintiff

By .....
J. Vernon Patrick, Jr.

DEMAND FOR TRIAL BY JURY

Plaintiff respectfully demands trial by jury. This 21st day of November, 1968.

Of Counsel for Plaintiff

VERIFICATION

STATE OF ALABAMA
JEFFERSON COUNTY

Before me, a Notary Public in and for said State, this date appeared J. Vernon Patrick, Jr., known by me, who being by me first duly sworn deposes and says as follows:

I am attorney for plaintiff herein and have investigated the allegations in the above and foregoing Amended Complaint and they are true and correct except such allegations as are made on information and belief, and as to those, I am informed and verily believe them to be true and correct.

J. Vernon Patrick, Jr.

Sworn to and subscribed before me this 21st day of November, 1968.

Notary Public

CERTIFICATE OF SERVICE

I hereby certify that I have this date served a copy of the above Amended Complaint on all parties hereto by mailing their counsel of record a copy thereof.

This the 21st day of November, 1968.

Attorney for Plaintiff

APPENDIX II
IN THE
UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

No. 27,385

EDWIN J. HERPICH, on behalf of himself and all other stockholders (other than defendant Wilder and persons in conspiracy with him) of National American Life Insurance Company,

Appellant,
(Plaintiff in Court Below)

versus

ROBERT E. WILDER; and NATIONAL AMERICAN LIFE INSURANCE COMPANY, a Louisiana corporation,

Appellees.
(Defendants in Court Below)

Appeal from the United States District Court for the Middle District of Alabama, Northern Division

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BRIEF FOR APPELLANT EDWIN J. HERPICH

STATEMENT OF ISSUES PRESENTED FOR REVIEW

1. Did the trial court err in dismissing Count II of the Amended Complaint for failure to state a cause of action under SEC Rule 10b-5, and in entering judgment for defendants based on said dismissal, where the Amended Complaint alleges that defendant Wilder, while President and Chairman of the

Board of National American Life Insurance Company, sold his shares of stock in and "control" of National American Life at a premium greatly in excess of the market value of his said shares, alleges that part of the purchase price paid Wilder was paid by National American Life, alleges that the purchaser bought said shares in order to divert to the purchaser National American's assets, alleges that defendant Wilder cast the transaction as a sale of his stock for his personal benefit rather than in such a manner as to benefit all stockholders of National American Life, and alleges that defendant Wilder never accounted and never intended to account to National American Life Insurance Company or to its stockholders for said premium?

2. Did the trial court err in dismissing Count III of the Amended Complaint for failure to state a cause of action under SEC Rule 10b-5, and in entering judgment for defendants based on said dismissal, where the Amended Complaint alleges that National American Life was damaged because defendant Wilder caused it to pay an exorbitant purchase price to one Harris for shares of stock of another company under the pretext, guise or contrivance of a "loan" to Harris, on which there was no personal liability, "secured" by a pledge of the shares so purchased?

3. Did the trial court err in dismissing Count IV of the Amended Complaint for failure to state a cause of action under SEC Rule 10b-5, and in entering judgment for defendants based on said dismissal, where the Amended Complaint alleges that National American Life Insurance Company was damaged because Wilder caused National American Life In-

surance Company to lend $100,000.00 to one Raymond A. Latta to finance Latta's purchase of shares of stock of Dawl Corp., that shares of stock of First Colonial Corp. were then substituted for the Dawl shares as security pledged for the loan, that said First Colonial shares were and are worth less than the amount of the loan, and that in connection with said purchase of Dawl shares, Wilder caused National American Life Insurance Company to pay Latta an additional $45,000.00 for no consideration?

4. Did the trial court err in dismissing Count I of the Amended Complaint for failure to state a cause of action under the Investment Company Act of 1940 on behalf of National American Life and on behalf of its stockholders other than Wilder and in entering judgment for defendants based on said dismissal, where the Amended Complaint alleges that in violation of the Investment Company Act of 1940, defendant Wilder caused National American Life Insurance Company to be dominated by First Colonial Corp. of America (alleged to be an unregistered investment company), caused National American Life to lend more than One Million Dollars on inadequate security to First Colonial Corp. of America, caused National American Life to guarantee obligations of First Colonial Corp. of America, and caused National American Life to engage in purchases and sales of securities and in interstate commerce with First Colonial Corp. of America, all to the damage of National American Life Insurance Company and its stockholders?

SUPREME COURT, U. S.

Supreme Court, U.S.
FILED
JAN 29 1971
E. ROBERT SEAVER, CLERK

IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1970

No. 1078

EDWIN J. HERPICH, on Behalf of All the Stockholders of National American Life Insurance Company,
Petitioner,

vs.

ROBERT E. WILDER and NATIONAL AMERICAN LIFE INSURANCE COMPANY, a Louisiana Corporation,
Respondents.

SUPPLEMENTAL BRIEF FOR PETITIONER IN SUPPORT OF HIS PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

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IN THE

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Pursuant to Rule 24 of the Supreme Court Rules, this Supplemental Brief for Petitioner is respectfully filed to call to the Court's attention an *amicus curiae* brief (reproduced hereinafter as an appendix hereto) filed by the United States Securities & Exchange Commission in January, 1971 in **Levine v. Seilon, Inc.**, now pending in the Second Circuit.

In the appended *amicus* brief, the SEC has argued forcefully that the "purchaser-seller" limitation on civil actions brought for violations of Rule 10b-5 is inconsistent with the purpose of the 1934 Act and denies relief to persons within the class Congress intended to protect. This construction of the 1934 Act by the administrative agency charged with enforcement of the 1934 Act is believed to be of great relevance to the issues presented to this Court in our petition for certiorari in Case No. 1078 now under submission.

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APPENDIX

TEXT

SEC AMICUS BRIEF ON LEVINE V. SEILON, INC. (CA. 2, ARGUED 1/13/71)

The Securities and Exchange Commission ("Commission") submits this brief, amicus curiae, pursuant to leave of this Court granted by order dated December 24, 1970, on whether the complaint states any claim for relief under Sections 14(e) or 10(b) of the Securities Exchange Act of 1934 ("Act"), 15 U.S.C. 78n(e) and 78j(b), and Rule 10b-5, 17 CFR 240.10b-5 promulgated thereunder.

STATEMENT OF THE CASE

Irving Levine, a former preferred shareholder of Seilon, Inc., brought this action for damages under Sections 14(e) and 10(b) of the Securities Exchange Act of 1934 ("the Act") and Rule 10b-5 thereunder, alleging that the defendant, Seilon, Inc. ("Seilon"), a New York Stock Exchange listed company, perpetrated a scheme to defraud its preferred shareholders. The action was brought by the plaintiff on his own behalf and on behalf of all other former owners of preferred stock of Seilon similarly situated (22a)[1] The amended complaint[2] in essence alleges the following:

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[1] "a" refers to the appendix to appellant's brief.

[2] The amended complaint repeats in a greater detail the allegations of the original complaint and is assumed in this brief to be the basis upon which plaintiff has stated a claim under both Sections 14(e) and 10(b). The Commission recognizes that defendant-appellee views the pleadings somewhat differently, Brief of Appellee pp. 3-8 and 32, although it apparently recognizes (p. 6) that "both complaints make basically the same assertions."

Seilon desired to create new funded debt to proceed with a program of corporate acquisitions (27a) but such new debt required the prior approval of two thirds of Seilon's preferred shareholders (24a 25a).

In order to obtain this authorization, on June 6, 1968, Seilon told its preferred holders that it would give them six and one half shares of Seilon's common stock for each of their preferred shares (27a 28a). Since the preferred stock was held subject to a call for redemption (24a), Seilon also assured its preferred holders that it would not redeem any of their shares until after the intended exchange offer had terminated (27a).[3] In fact, when Seilon made these public announcements, it secretly intended and planned to redeem the preferred shares without offering any exchange of common stock (27a 28a).

Seilon's scheme entailed twin courses of action. At the same time it engaged in delaying tactics and further misrepresentations with respect to its announced exchange offer, it proceeded to enter into a series of financial transactions designed to raise, if possible, the necessary cash to redeem (29a 30a).[4] The company knew that the So-

[3] The announced ratio of common stock for preferred would have been worth substantially more than the redemption price and was intended to and did artificially inflate the market prices of preferred shares (28a; 35a).

[4] It is fundamental that on a motion to dismiss, the complaint must be construed most favorable toward the plaintiff, **see A. T. Brod & Co. v. Perlow**, 375 F.2d 393, 397 (C.A. 2, 1967). Although the complaint is far from a model of clarity, nevertheless, so construed, it implies that Seilon intended to redeem the preferred shares because this would have obviated the need to offer a more expensive exchange of common stock to obtain the preferred holders' requisite approval of new funded debt. It further appears that Seilon continued its delaying tactics and misrepresentations with respect to the exchange offer in order to, on the one hand, provide the company time to raise the money for a redemption and on the other, to, if necessary, proceed with the common stock exchange if it turned out that in

curities Act of 1933 exempted the common stock in the exchange offer from this Act's registration requirements (28a). Nevertheless, Seilon told its preferred shareholders on June 6, 1968 that such a registration was required to effect the exchange (27a). After a willful delay of three months, on September 10, 1968, the company filed a fraudulent registration statement to cover the common stock to be exchanged for preferred (30a). This registration statement reaffirmed that Seilon would begin its exchange offer "as soon as practicable" and that the company did not intend to redeem any preferred shares until such offer terminated (31a). Following the bogus filing, the company began to solicit the preferred holders to accept said exchange offer (31a).

While it engaged in the fraudulent activities described above, Seilon was also proceeding in accordance with its scheme to try to raise sufficient money to redeem the preferred shares without offering any exchange. There were certain stock holdings which Seilon had pledged to a bank as collateral for notes payable. In June 1968 the company sold these investments and deposited instead the cash proceeds as collateral. Seilon then formed in June a new corporation, Lockwood, Inc., and exchanged the assets of one of Seilon's operating divisions for 1,000,000 Lockwood shares (29a 30a). On September 27, 1968 Lockwood filed with the Commission a Form S-1 Registration Statement for the public sale and issuance of its common stock (32a). On the basis of this proposed public offering[5] Seilon

fact Seilon could not finance the necessary cost of a redemption. No doubt the complaint leaves several questions unanswered. These questions, however, do not appear sufficiently significant to warrant dismissal. **Cf. Schoenbaum v. Firstbrook**, 405 F.2d 215, 218 **(en banc** —C.A. 2, 1968), **certiorari denied sub. nom., Manley v. Schoenbaum**, 395 U.S. 906 (1969).

[5] Before becoming effective, such a public offering would also have had to have had the approval of the preferred shareholders (30a).

managed sometime after October 1968 to raise the cash necessary to redeem. In accordance with its scheme, it substituted as collateral the Lockwood shares to be offered publicly for the cash collateral deposited earlier in the bank. With the funds thus released, Seilon announced a redemption of all preferred shares on December 10, 1968 (32a).[6] The rights of the preferred shareholders were thereafter terminated and their shares involuntarily converted into a claim for the cash amount of the redemption price (33a-34a).[7]

Seilon's scheme, which successfully opened the way for the creation of new funded debt, had the intent and effect of: (1) artificially inflating the market price of the preferred shares; (2) misleading the preferred shareholders into retaining their holdings when they could have sold them on the market at a higher price, (3) misleading the public into buying preferred shares and inducing the preferred shareholders to consent to new credit arrangements which they had previously refused to approve (28a-29a; 35a).[8]

The preferred shareholders, in furtherance of the fraud perpetrated by Seilon, were forced to accept the redemption price. But for the fraud which culminated in the redemption of the preferred shares, the plaintiff alleges he

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[6] In this manner Seilon avoided the higher costs of having to make the exchange offer to obtain the preferred shareholders' approval of new funded debt. **See infra** note 7.

[7] The public files of the Commission (No. 2-30091-1) reveal that on January 9, 1969, Seilon withdrew the registration statement covering the proposed exchange offer. In a letter to the Commission dated January 7, 1969, Seilon justified the withdrawal by stating that the exchange offer would have cost the company nearly two million dollars more than the cost of a redemption.

[8] The complaint does not say if these new credit arrangements were related to the means by which Seilon obtained the necessary cash to redeem.

would have accepted the Exchange Offer (35a). On behalf of all former owners of preferred stock similarly situated, plaintiff claims as damages the difference between the redemption price and the value of the common stock package which Seilon fraudulently assured the public it would offer in exchange for its preferred shares (22a; 36a).

On Seilon's motion, the court below dismissed the original and amended complaints and held that: (1) Section 14(e) of the Act did not apply because "no tender offer was made in this case" and Section 14(e) "appear[s] to have been intended to prevent misrepresentations with respect to tender offers or invitations for tenders that are actually made" (19a) and (2) that no claim had been stated under Section 10(b) and Rule 10b-5 thereunder because the delivery of preferred stock for redemption was not a "sale" and alternatively, even if the redemption were a "sale," the alleged fraud was not "in connection with" the redemption (42a; 43a).

ARGUMENT

I. The Complaint States a Claim for Relief in Favor of Plaintiff Under Section 14(e)

It is the Commission's contention that the anti-fraud provision of the 1968 tender offer amendments to the Act, Section 14(e), does not require that the fraud be in connection with tender offers, requests or invitations for tenders that are "actually made" as distinguished from those which have not yet commenced. This section prohibits fraud or misstatements "in connection with **any** tender offer, request or invitation for tenders or any solicitation . . . in opposition to or in favor of any such offer. . . ." Section 14(e) is intended to affirm that anyone "seeking to influence the decision of investors **or** the outcome of [a] tender offer" (emphasis added) has a duty

to disclose all material information to those with whom he deals.[9] The purpose of Section 14(e) is to help maintain an honest securities market by ensuring that public investors have truthful information to make investment decisions when a tender offer could affect that decision.[10] Since the market may be manipulated by a fraudulent announcement of an intent to make a tender offer as well as by deception in the tender offer itself, the Commission urges that Section 14(e) be construed to give effect to its broad antifraud purpose.[11] The terms of Section 14(e) are deliberately inclusive. In the Commission's view, fraud in the announcement of intent to make a tender offer is, under the terms of the section, "in connection with any tender offer."[12]

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[9] Both the House and Senate Reports on the Williams Act (House Report No. 1711, 90th Cong., 2nd Sess. p. 11; Senate Report No. 550, 90th Cong., 1st Sess. pp. 10-11) state:

> "Proposed subsection (e) would prohibit any misstatement or omission of a material fact, or any fraudulent or manipulative acts or practices, in connection with **any** tender offer, whether for cash, securities or other consideration, or in connection with any solicitation of security holders in opposition to or in favor of **any** tender offer. This provision would affirm the fact that persons engaged in making or opposing tenders **or otherwise seeking to influence the decision of investors or the outcome of the tender offer** are under an obligation to make full disclosure of material information to those with whom they deal" (emphasis added).

[10] Such a construction of Section 14(e) supplements the intent of the Securities Exchange Act of 1934 which was enacted "to insure the maintenance of fair and honest markets" for securities. Section 2, 15 U.S.C. 78b.

[11] ". . . remedial legislation should be construed broadly to effectuate its purposes. The Securities Exchange Act quite clearly falls into the category of remedial legislation." **Tcherepnin v. Knight**, 389 U.S. 332, 336 (1967).

[12] This view is consistent with Congress also prohibiting in Section 14(e) fraudulent conduct "in connection with . . . **any solicitation** "relating to a tender offer. That term has been broadly defined under Section 14(a) of the Act and has been

The district court's interpretation of Section 14(e) is fundamentally inconsistent with other provisions of the Williams Act. Section 13(d)(1) prevents **potential** tender offerors from acquiring, by open market or private purchases, too large a block of stock in a company before such persons' identity and **intentions** are made known to the public and management. Since Congress obviously **believed that the disclosure** of intentions under certain situations was necessary for the protection of investors, it would be contradictory, if not self-defeating, to construe the antifraud provision of the legislation as not applying to fraudulent misstatements of a person's intent to make a tender offer when such disclosure is required by Section 13(d) itself.

If, after a person's acquisition of beneficial ownership of any equity security of a publicly held company, he beneficially owns more than 10 percent of the securities of that class, Section 13(d) requires him to file a statement

so interpreted by this Court, **Studebaker Corp. v. Gittlin**, 360 F.2d 692 (1966). The similarities between the proxy rules and the tender offer legislation has also been recognized by this Court, **Electronic Specialty Co. v. International Controls Corp.**, 409 F. 2d 937, 1,948 (1969). As this Court stated in **Studebaker** in referring to **Securities and Exchange Commission v. Okin**, 132 F.2d 784 (1943), it had long been recognized that "a letter which did not request the giving of any authorization was subject to the Proxy Rules if it was part of 'a continuous plan' intended to end in solicitation and to prepare the way for success." **Studebaker, supra,** 360 F.2d at 696. To hold otherwise would mean, as Judge L. Hand said in **Okin**, that "one need only spread the misinformation adequately before beginning to solicit, and the Commission would be powerless to protect shareholders." 132 F. 2d at 786. There is nothing in the legislative history of the tender offer amendments to suggest that Congress intended the term "solicitation" to be more narrowly construed here than it had been in the proxy area. Indeed, the Commission has recognized that the need for protection of the stockholder "may be greater in the case of the tender offer than in a proxy dispute." **In the matter of Reports of the Susquehanna Corp.** Securities Exchange Act Release No. 8933 (July 17, 1970) CCH Fed. Sec. L. Rep. par. 77, 842 at p. 83,987.

of information (Schedule 13D).[13] For example, when the purpose of such a person's "prospective purchases" (emphasis added) is to gain control, he must disclose his "plans" to liquidate, merge or make any other major change in the issuer's business or structure.[14] Moreover, under Schedule 13D promulgated by the Commission pursuant to Section 13(d),[15] such a person must disclose, in any event, just what the "purpose or purposes of the issuer" is.[16]

Should Schedule 13D, which covers such past, "prospective" and "proposed" purchases, "relate to" a tender offer, request or invitation for tenders, additional information is required.[17] Section 13(d)(1) therefore, requires that the plans and purposes surrounding prospective tender offers be disclosed. In addition, under Schedule 13D persons owning a substantial amount of securities must disclose the fact that their acquisitions are intended to facilitate or defeat possible tender offers by themselves or other persons.

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[13] The subsection applies to persons who beneficially own more than 10 percent of a class before the acquisition as well as to persons who become the beneficial owners of more than 10 percent of the class as a result of the acquisition.

[14] Section 13(d)(1)(C), 15 U.S.C. §78m(d)(1)(C) (Supp. IV, 1969). See **Susquehanna Corp., supra**, Securities Exchange Act Release No. 6933. **Compare Susquehanna Corp. v. Pan American Sulphur Co.**, 423 F.2d 1075 (C.A. 5, 1970).

[15] Section 13(d)(1), 15 U.S.C. § 78m(d)(1) (Supp. IV, 1969), grants the Commission authority to require the disclosure of "such additional information, as the Commission may by rules and regulations prescribe as necessary or appropriate in the public interest or for the protection of investors . . ." (emphasis added).

[16] Schedule 13D, Item 4, "Purpose of Transaction."

[17] **Id.**, Item 7, "Persons Retained, Employed or To Be Compensated."

It is clear that if fraudulent disclosures in connection with such future tender offers are held to be beyond the reach of the Williams Act's anti-fraud provisions, the protection afforded to the public by Section 13(d) (1) will be undercut. For example, consider the not uncommon situation where corporations "A" and "B" are both apparently seeking control of target company "T". In the course of laying the groundwork for a tender offer to T stockholders, A acquires more than 10 percent of T's stock and files Schedule 13D pursuant to Section 13 (d) (1) and Regulation 13D thereunder.[18] In order to defeat A's prospective tender offer, B who has also acquired more than 10 percent of T's stock and must therefore file its own Schedule 13D, falsely states therein that it intends to make a tender offer to T shareholders at a better price than A. As a result, as planned by B, the market price of T shares is inflated to prohibitive level and a successful tender offer by A is rendered impossible before it is ever made. B's motive may be to defeat A's prospective tender offer in order to make its own offer possible at some unannounced date when the price of T shares has declined, or B may simply have made its false statement of intent because it entered into a collusive agreement with T's management to defeat A's prospective tender offer.[19] Certainly when Congress

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[18] Among other things, A must thereby disclose: that the "purpose" of his purchases of T stock is to lay the groundwork for a tender offer he intends to make to T shareholders (Schedule 13D, Item 4); such "plans" within the meaning of Section 13 (d) (1) (C) as A may have and finally, that a certain amount of funds is "to be used" to make purchases of T stock (Section 13 (d) (1) (B)).

[19] A collusive agreement to defeat a third party's outstanding tender offer was the subject of litigation under Section 10 (b) and Rule 10b-5 thereunder in **Iroquois Indust., Inc. v. Syracuse China Corp.**, 417 F. 2d 963 (C. A. 2, 1969), **cert. denied**, 399 U.S. 909 (1970) and **Crane v. Westinghouse Air Brake Co.**, 419 F.2d 787 (C.A. 2, 1969), cert. denied, ... U.S. ... (1970).

required the disclosure of the plans and intentions of substantial owners of publicly held companies, it did not intend to exclude fraudulent disclosures of prospective tender offers from the reach of the Act's anti-fraud provision. Such a construction of the Williams Act makes the Act internally inconsistent. Fraudulent statements of intent to make a tender offer made pursuant to Section 13 (d) (1) should be considered, under the terms of Section 14 (e), to be "in connection with any tender offer" and therefore unlawful.

Unlike Section 13 (d) (1), Section 14 (d) of the Williams Act requires that Schedule 13D be filed at the time a tender offer is made and published. However, this provision is not inconsistent with the above interpretation of 13 (d) (1) and the reasons underlying Section 14 (d) are unrelated to a proper interpretation of Section 14 (e).

Congress did not require disclosure under Section 14 (d) when a company first reached an intent to make a tender offer (as opposed to the time the offer was made) because a public announcement of the circumstances surrounding such an intent would create unjustified market expectations particularly since the announcement itself might ultimately prevent the tender offer's consummation by raising the price of the target company's securities.[20] As secrecy was recognized as frequently being important to the success of most takeover bids, it seemed inappropriate to require disclosure at the time a company first intended to make an offer.[21] Such considerations are not relevant

[20] Moreover, the substantive protections under 14 (d) of withdrawal rights, pro rata acceptance, and equal price treatment necessarily presume a tender offer which is ongoing.

[21] An early draft of the Williams legislation, S. 2731, 89th Cong., 1st Sess. (1965), would have required an offeror whose proposed acquisition would result in more than 5% beneficial ownership to inform the target of its intentions twenty days before making the tender offer. The Commission recommended

to the requirement under Section 13 (d) (1) that plans and purposes surrounding a **prospective** tender offer be disclosed. Congress recognized that the acquisition of more than a ten percent interest in a company might well presage a change in control and that the investing public was entitled to know the facts bearing on the desirability of tendering its shares at a particular price. Thus, in this particular situation as distinguished from those covered in Section 14 (d)'s disclosure prior to a contemplated tender offer of the identity and intentions of the persons responsible for such large acquisitions seemed advisable and was required.

In short, the provisions of both Section 13 (d) (1) and 14 (d) of the Williams Act are addressed to the question of **when** the law should **require** that certain information be publicly disclosed. They afford no justification for the view that mere voluntary announcements are made pursuant to a prospective tender offer, such announcements need not comport with the Act's anti-fraud provisions.[22]

that the pre-offer disclosure period be reduced to five days. MEMORANDUM OF THE SECURITIES AND EXCHANGE COMMISSION TO THE COMMITTEE ON BANKING AND CURRENCY, U.S. SENATE ON S. 2731, 112 Cong. Rec. 19083-86 (1966) and the five day provision was incorporated into the House's version of the 1968 legislation, H.R. 14475, 90th Cong., 2nd Sess. (1968). Largely in response to objections that the five day pre-offer notice requirement would result in leaks and market manipulation, see **Hearings on H.R. 10475 before the Subcommittee on Commerce and Finance of the House Committee on Interstate and Foreign Commerce**, 90th Cong., 2nd Sess. at 43-47 (1968) and **Hearings on S. 510 Before the Subcommittee on Banking and Currency**, 90th Cong., 1st Sess. at 69-106 (1967), the version of Section 14 (d) which was finally enacted contains no provision for advance notice to the target company and filing is required only at the time the tender offer is first made and published.

[22] As discussed **supra** pp. 11-12, under Section 13 (d) (1) a prospective offeror may be required to state his intentions publicly. **A fortiori**, Section 14 (e) should apply to such announcements whether or not the prospective offeror follows through with his intentions.

Paragraph (8) of Subsection 14 (d) contains certain exemptions from its requirements, but again, for reasons which relate

This interpretation of the anti fraud provision is consistent with other similar situations under the federal securities laws where the antifraud provisions have been held applicable, even though a particular event or transaction is exempt from certain filing requirements.[23]

The fact that secrecy is often crucial to the success of an intended takeover may in part explain why public disclosure is not required under Section 14 (d) until the offer is actually made. An offeror's interest in secrecy, however, does not restrict the use of deliberate fraud which

only to this subsection's particular purposes. There are exemptions, for example, from 14(d) for tender offers proposed to be made by a registration statement and for tender offers by an issuer for the issuer's own securities. Congress believed, in the case of exchange offers of stock, that registration under the Securities Act of 1933 provided adequate disclosure. The exemption for tender offers by an issuer for the issuer's own securities presumably results from the fact that the Commission was given authority under section 13(e)(1) to adopt rules defining fraudulent practices in connection with an issuer's repurchase of its shares. These distinctions are not in the antifraud provision (Section 14(e)) because they are irrelevant to the broad purpose of this section which is to prohibit fraud in connection with tender offers. Thus, Section 14(e) would apply to fraudulent exchange offers of stock, fraudulent tender offers by an issuer for its own securities and fraudulent tender offers which have not yet commenced, although all of these may not be subject to the disclosure provisions of Section 14(d).

[23] Indeed, in the landmark decisions which first recognized the private right of action under Rule 10b-5, it was held that Rule 10b-5 was applicable even though the stock was "not registered on an exchange nor traded in the over-the-counter market, and no security dealer or broker was used in effecting the purchases." **Robinson v. Difford**, 92 F. Supp. 145, 147 (E.D. Pa. 1950), **accord. Kardon v. National Gypsum Co.**, 69 F. Supp. 512, 514 (E.D. Pa., 1946) and 73 F. Supp. 798 (E.D. Pa., 1947). **See also Northern Trust Co. v. Essaness Theatres Corp.**, 103 F. Supp. 954, 959-61 (N.D. Ill., 1952); **Speed v. Transamerica Corp.**, 99 F. Supp. 830-31 (D. Del., 1951); **Pratt v. Robinson**, 303 F. 2d 627 (C.A. 9, 1953), **Matheson v. Armburst**, 284 F.2d 670, 674 (C.A. 9, 1960) certiorari denied, 365 U.S. 870 (1961); Cf. **Securities and Exchange Commission v. National Securities, Inc.**, 393 U.S. 453 (1969).

to may attempt to perpetrate. For example, a company may fraudulently represent that it has no intent to make a tender offer in order to drive the price of the target company's securities down and facilitate a later bid, see **Electronic Specialty Co. v. International Controls Corp.**, supra, 409 F. 2d 937. This later bid may or may not in fact occur depending perhaps on the success of the fraud. It does not appear Congress intended the application of the antifraud provisions to turn on whether in fact the company did make a tender offer after having manipulated the price of the target company's shares.

Indeed, Section 14(e) proscribes "manipulative acts or practices" in connection with any tender offer.[24] In another instance, a target company may falsely state that it intends to make a tender offer to its own shareholders which will be more attractive than an outsider's intended bid. The purpose would be to inflate the price of the target company's own shares and thereby discourage or defeat the threatened offer. Once again, where such a defensive move succeeded in preventing the outsider's takeover bid, it would not seem that Congress would have intended that Section 14(e) not apply because the fraud here was, in fact, successful with result that no tender offer was "actually made."

Plaintiff, in the present case, alleges that Sedco fraudulently held out the promise of an exchange offer, an

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[24] As one writer has observed, Note, **Cash Tender Offers**, 83 Harv. L. Rev. 377, 397 (1970), the majority and dissent in **Electronic Specialty, supra,** both proceeded on the unarticulated assumption that pre-offer conduct can be a violation of Section 14(e), the antifraud provision. Section 14(e)'s 'in connection with' language extends beyond merely post-offer activities. This extension is especially significant in the case of market manipulations, because manipulation is likely to be most attractive before the offer itself. Courts should read generously the 'in connection with' language of Section 14(e) as a ban on manipulations in order not to rob the provision of its broad protective effect." (Footnote omitted.)

nounced its terms, falsely represented that no redemption would take place prior to the termination of the exchange offer, filed a fraudulent registration statement pursuant to the exchange offer and finally, solicited preferred shareholders to accept the proposal before redeeming the preferred shares.[25] Plaintiff alleges defendant thereby artifically inflated the price of the preferred stock, fraudulently induced the preferred shareholders to vote in favor of certain corporate matters and misled them into retaining their preferred holdings. The fact that no exchange offer was "actually made" was part of the fraud which is alleged to have been perpetrated. The Commission believes that such a fraud on the preferred holders was in connection with a tender offer within the intended meaning of Section 14(e). Plaintiff alleged a violation of the section and his complaint should not have been dismissed in this regard.[26]

II. Plaintiff Has Stated a Claim for Relief Under Section 10(b) of the Exchange Act and Rule 10(b)-5 Thereunder.

Although the Commission believes a cause of action under Rules 10b-5 is stated when, as in this case, an individual alleges that misrepresentations have influenced his judgment to buy, sell or hold securities and he has suffered damage thereby,[27] we recognize that this Court has often stated that recovery of damages under Rule 10b-5 is limited to persons who are actual purchasers or sellers of

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[25] Whether there was in fact a solicitation (See Brief of Appellee, p. 36) is irrelevant for purposes of this appeal.

[26] The Commission expresses no views on what might be the appropriate relief or measure of damages flowing from this violation of Section 14(e). Cf. Eahan v. Rosenthal, 424 F.2d 161 (C. A. 3, 1970), cert. denied, 398 U.S. 950 (1970).

[27] See discussion infra pp. 24-25.

the securities involved.[28] Accepting this view for present purposes, nevertheless, we believe plaintiff has stated a claim for relief on the ground that Seilon's redemption of preferred stock resulted in a forced sale of preferred shares in connection with the fraud alleged.

A. Seilon's Redemption Resulted in a "Forced Sale" in Connection with the Fraud Alleged.

The authority relied upon by the court below for its holding that Seilon's redemption did not give rise to a sale was **Securities and Exchange Commission v. Sterling Precision Corp.**, 393 F. 2d 214 (C. A. 2, 1968). **Sterling** held that an affiliate's redemption of its debentures and preferred stock held by the affiliated registered investment company did not constitute a "purchase" within Section 17(a)(2) of the Investment Company Act, 15 U.S.C., § 80a-17(a)(2). Certain purchases by such an affiliate are made unlawful under Section 17(a)(2) and the Commission had cited this prohibition as grounds for an injunction against the affiliate for failing to obtain the Commission's approval under Section 17(b), 15 U.S.C. 80a-17(b). In holding that the affiliate's redemptions did not constitute a Section 17(a)(2) "purchase," this Court looked to the particular dangers which the Investment Company Act sought to remedy. It noted that despite the fact that "Congress was principally concerned with protecting the assets of investment companies from unscrupulous management," Congress nevertheless permitted affiliates "to sell" back an investment company's securities without Commission approval.[29]

Moreover, there was no dispute in **Sterling** that redemptions by the investment company constituted such

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[28] **See e.g., Greenstein v. Paul**, 400 F.2d 580 (C.A. 2, 1968); **Iroquois Industries, Inc. v. Syracuse China Corp., supra.**

[29] **Sterling Precision, supra**, 393 F. 2d at 218.

exempted "sales" within the meaning of the Act. Thus, this Court reasoned that "if Congress believed that redemptions of this type [i.e. by an investment company] could safely be left unsupervised, it follows a fortiori that redemptions by 'affiliates' . . . should also be."[30] The court concluded that any danger presented to the investment company by an affiliate's redemptions "was not one of the principal evils the Act sought to remedy."[31]

In short, Sterling rests on an interpretation of the purpose of Section 17(a)(2) of the Investment Company Act[32] and should not, therefore, determine the scope of "sale" as used in an anti-fraud provision of the Securities Exchange Act, a provision designed to serve different objectives. The Supreme Court has cautioned that various sections of the securities laws must be interpreted in their

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[30] Id.

[31] Id. at 219. The court also relied upon the fact that Congress used the terms "redemption" and "purchase" separately in the Investment Company Act.

[32] The court below apparently overlooked this fact. In reasoning fr n the holding in Sterling, Judge McLean said, "If a corporation which redeems its preferred stock does not thereby 'purchase' it, it would seem to follow that the stockholder who delivers it for redemption does not 'sell' it" (42a). Actually, Sterling only held that redemptions by corporations who are affiliates of investment companies are not "purchasers" within the Investment Company Act. Everyone agreed that when it was the investment company that redeemed instead of the affiliate, a "sale" of stock resulted. The presence, in the context of a redemption, of a "sale" on the one hand, but "no purchase" on the other, depended on whether it was the investment company or the affiliate that was redeeming. This, in turn, resulted from the statutory scheme and the court's interpretation of it in Sterling.

The court below also referred to the reasoning in Sterling that words should be given their normal meaning (42a), but this would seem to have more force in construing the Investment Company Act where "purchase" is left undefined, than in interpreting the meaning of "sale" as defined by Congress in the Exchange Act.

own contexts.[33] Whereas Congress left "purchase" undefined in the Investment Company Act, it spoke directly to the meaning of both "purchase" and "sale" as used in the Exchange Act. Congress said that unless the context otherwise requires, a "purchase" under the Exchange Act includes "any contract to buy, purchase or **otherwise acquire**" and a "sale" includes "any contract to sell or **otherwise dispose of**." (Emphasis added.) As "has been pointed out . . . the verb 'includes,' rather than the verb 'means,' emphasizes the breadth of this definition . . . and the phrases 'or otherwise acquire' and 'or otherwise dispose of' are hardly limiting."[34] While the Supreme Court recently noted that this language indicates the breadth of the statutory terms, it stated that in determining whether alleged conduct is "in connection with the purchase or sale of any security," the question to be asked is whether the conduct is "the type of fraudulent behavior which was meant to be forbidden by the statute and rule"—not merely whether what occurred fits literally within the statutory definitions.[35]

The context of Section 10(b) does not "otherwise require" this Court to depart from the broad concepts of "purchase" and "sale" adopted by Congress in the Exchange Act. Indeed, it is fundamental that the Exchange

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[33] "[B]oth the 1933 and 1934 Acts preface their lists of general definitions with the phrase 'unless the context otherwise requires' . . . We must therefore address ourselves to the meaning of the words 'purchase or sale' in the context of Sec. 10(b). Whatever these or similar words may mean in the numerous other contexts in which they appear in the securities laws, only this one narrow question is presented here." **Securities and Exchange Commission v. National Securities, Inc.**, 393 U.S. 453, 466 (1969).

[34] **Vine v. Beneficial Finance Co.**, 374 F.2d 627, 634 (C.A. 2, 1967), **certiorari denied**, 389 U.S. 970 (1967).

[35] **Securities and Exchange Commission v. National Securities, Inc.**, **supra** at 467.

Act must be construed broadly to effectuate its remedial purpose.[36] When through an acquisition or disposition of securities a person may be defrauded, a "purchase" and "sale" has occurred within the intended meaning of Section 10(b). Because a redemption involves a surrender of securities for cash, as a practical matter, the exercise of a redemption right may occur under circumstances which have the effect of defrauding shareholders. For example, if fraudulent representations concerning a possible redemption affect the judgment of investors so that they retain their securities and are thereby forced to accept a redemption price instead of a higher amount which would have been otherwise available, these persons have a claim as "forced sellers" under Section 10(b) and Rule 10b-5 for resulting damages. There is little reason to distinguish a redemption from a forced sale under the short form merger statutes,[37] a forced sale as part of a corporate liquidation[38] or a forced sale under threat of divestiture for possible anti-trust violations.[39] In each situation the stockholders' rights are frozen and "as a practical matter," he is forced to accept cash for his stock. Thus, he "must eventually become a party to a 'sale' as that term has always been used."[40]

Prior to the announced redemption, in the instant case plaintiff had the option of selling the preferred shares at a higher price on the market. However, he was misled into retaining his shares on the basis of the false repre-

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[36] **Teherepnin v. Knight**, note 11 **supra**.

[37] **Vine v. Beneficial Finance Co.**, note 34 **supra**.

[38] **Coffee v. Permian Corp.**, No. 29093 (C.A. 5, November 23, 1970).

[39] **Crane v. Westinghouse Air Brake Co.**, 419 F.2d 787 (C.A. 2, 1969), **certiorari denied**, ... U.S. ... (1970).

[40] **Vine v. Beneficial Finance Co.**, note 34 **supra**, at 634.

sentation that his shares would **not** be redeemed prior to the expiration of the exchange offer. Once that offer was withdrawn and the redemption announced, he was "forced" to offer the shares in redemption.

Alternatively, the court below held that even if the redemption gave rise to a "sale" within the statute and rule, the alleged fraud was not "in connection with" this redemption (43a). The court explained:

> "The essential fraud is the representation that defendant would exchange common stock for preferred. (Footnote omitted.) It is because defendant failed to do this that plaintiff allegedly sustained injury. Defendant had the right under its charter to redeem its preferred stock for cash, as it eventually did" (43a).

Thus, the court apparently held that since the fraud alleged contributed nothing to the corporation's power to redeem, the fraud was not "in connection with" that redemption. We believe the court misconstrued plaintiff's complaint. That Seilon may always have had a corporate right of redemption is no answer to the contention that it exercised this right fraudulently or that apart from such fraud, it could not have raised the money necessary to redeem.[41]

In order to recover damages under Section 10(b) and Rule 10b-5 a plaintiff must prove that misstatements in connection with a purchase or sale of a security in fact caused him to suffer injury. **List v. Fashion Park, Inc.**, 340 F.2d 457, 463 (C.A. 2, 1965), **certiorari denied sub nom., List v. Lerner**, 382 U.S. 811 (1965).[42] In this case plaintiff alleged that a fraudulent scheme involving a redemption

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[41] This latter contention appears to be implicit in the complaint.

[42] "What must be shown is that there was deception which misled Class A stockholders and that this was in fact the cause of plaintiff's claimed injury." **Vine v. Beneficial Finance Co.**, note 34 supra, at 635.

caused him injury.[42] The lower court held no claim had been stated because Seilon always **could have** redeemed its preferred shares and that therefore the alleged fraud was not "in connection with" such redemption (43a). In so holding, the court failed to recognize that plaintiff alleges Seilon's redemption was fraudulent because the redemption had occurred under false pretenses. That is, plaintiff alleges that Seilon had intended to redeem when it repeatedly assured the public and its preferred stockholders that it would not (28a; 30a-31a).

Thus, fraudulent misstatements not only were "in connection with" the redemption, they were an integral part of it. Certainly Seilon could have acted otherwise than alleged. Perhaps, it could have used its power to redeem without misleading the preferred shareholders. The fact is that for purposes of this appeal[44] it did not, and plaintiff alleges he thereby suffered damages. Whether a redemption untainted by fraud would have occurred in any case and caused the same injury to plaintiff, is not ascertainable from the pleadings at issue.

> "Defendants cannot accomplish by deception what they might have accomplished honestly and then be heard to say that the deception was not the cause. Lawsuits are determined by what was and not what might have been."[45]

[42] A single scheme which includes all of Seilon's fraudulent activities is alleged in § 21 of the amended complaint. Paragraph 25 states: "But for frauds culminating in the redemption acquisition, the plaintiff and all other members of the class would have accepted the Invitation for Tenders and would have tendered their preferred shares."

[44] The complaint must be taken as true and any ambiguities resolved in favor of the plaintiff. **A. T. Brod & Co. v. Perlow**, 375 F.2d 393, 397 (C.A. 2, 1967).

[45] **Eagle v. Horvath**, 241 F. Supp. 341, 343 (S.D.N.Y., 1965); **Swanson v. American Consumer Industries, Inc.**, 415 F. 2d 1326, 1331-32 (C.A. 7, 1969); **Laurenzano v. Einbender**, 264 F. Supp. 356 (E.D.N.Y. 1966); **see also Rosenblatt v. Northwest Airlines, Inc.**, No. 35602 (C.A. 2, December 3, 1970).

Of course appellant may not be able to prove his alleged damages by showing, for example, that but for Seilon's fraudulent scheme there would have been an exchange offer which he would have accepted. In the Commission's view, this is a matter which need not and should not be determined summarily on a motion to dismiss.[46]

B. Plaintiff Has a Claim for Relief Under Section 10(b) and Rule 10b-5 Since He Alleges That Misrepresentations Affected His Investment Judgment and He Suffered Damages Thereby.

Although the Commission believes plaintiff has standing under Section 10(b) as set forth **supra**, the Commission urges the Court not to rely upon this circumstance. There should be a remedy for all persons who have been proximately injured by a violation of an antifraud provisions.[47] Those who are fraudulently induced to retain securities and are injured thereby are no less deserving than other victims of manipulative or deceptive devices who happen to be purchasers or sellers. Assuming the truth of plaintiff's allegation, Seilon clearly violated Section 10(b) and Rule 10b-5, and but for the analysis set forth **supra**, he lacks standing under the traditional analysis to seek damages for the injury suffered because he has not made a completed purchase or sale of securities. This principle was first enunciated in this Court's opinion in **Birnbaum v. Newport Steel Corp.**, 193 F. 2d 461, **certiorari denied**, 343 U.S. 956 (1952). This so-called "purchaser-seller" requirement has been the subject of nu-

[46] See **Schoenbaum v. Firstbrook**, 405 F.2d 215, **218 (en banc** C.A. 2, 1968), **certiorari denied sub nom., Manley v. Schoenbaum**, 395 U.S. 906 (1969).

[47] See **Fischman v. Raytheon Mfg. Co.**, 188 F. 2d 783 (C.A. 2, 1951). Private rights of action are "a necessary supplement" to the Commission's own enforcement activities, **J. I. Case Co. v. Borak**, 377 U.S. 426, 432 (1964); **Mills v. Electric Autolite Co.**, 396 U.S. 375 (1970).

merous decisions of this Court[48] and other courts of appeals[49] and was briefly adverted by the Supreme Court in its decision in **Securities and Exchange Commission v. National Securities, Inc.**, 393 U.S. 453, 467, n. 9 (1969). Indeed, we recognize that this Court has recently stated, in **Superintendent of Insurance, supra**, 430 F. 2d at 359, n. 8, that

> "nothing in the cited cases undermines the now well-settled purchaser-seller rule of **Birnbaum**, especially in view of its recent reaffirmation in **Greenstein** [**v. Paul**, 400 F. 2d 580 (C.A. 2, 1968)]."

Further, the Commission recognizes that the substance of this argument was urged by the Commission in **Iroquois, supra**, and rejected by this Court. However, it appears that much of this argument was adopted by this Court in **Crane, supra**, which the Court of Appeals for the Third Circuit recently stated

> "makes it clear that there is no longer a **per se** requirement that plaintiffs in a 10(b) suit be defrauded purchasers or sellers. In **Crane**, a unanimous panel, including Chief Judge Lumbard who joined in the **Iroquois** decision, held that an action for injunctive relief could be brought by one who was not a purchaser or seller provided there was a casual connec-

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[48] Among the most recent decisions of this Court discussing this so-called test are **Superintendent of Insurance v. Bankers Life and Casualty**, 430 F. 2d 355 (1970), **petition for writ of certiorari filed**, 39 U.S.L.W. 3287 (U.S. Jan. 5, 1971) (No. 25); **Crane Co. v. Westinghouse Air Brake Co., supra**, 419 F. 2d 787; and **Iroquois Industries, Inc. v. Syracuse China Corp.**, 417 F. 2d 963 (1969), **certiorari denied**, 399 U.S. 909 (1970).

[49] Among the more recent decisions of other courts of appeals are: **Herpich v. Wallace**, 430 F. 2d 792 (C.A. 5, 1970), **petition for certiorari filed**, Supreme Court No. 1078; and **Kahan v. Rosenstiel**, 424 F. 2d 161 (C.A. 3, 1970), **certiorari denied**, 398 U.S. 950 (1970).

tion between the alleged violation of 10b-5 and the injury suffered by plaintiff."[50]

While the two cases can be distinguished on the ground that **Iroquois** was an action for damages and **Crane** was an action for injunctive relief, we believe that distinction to be unsound.[51]

We believe that the purchaser-seller requirement is neither compelled nor contemplated by the statutory language; that it is inconsistent with the statutory purpose, and that the decisions upholding this requirement weaken the enforcement of the Act by denying relief to persons who are within the class Congress intended to protect. Accordingly we urge that it not be adhered to. The expansion of the category of persons who may be considered "purchasers" or "sellers" as discussed **supra**, we also believe to be unsound. While one of the purposes of the purchaser-seller rule may have been to eliminate or discourage unnecessary or unsound litigation, we believe the result has been the opposite and has only served to further unnecessary and unwarranted motions and appeals.[52]

The Supreme Court has emphasized that the securities laws are to be construed "not technically and restrictively,

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[50] **Kahan, supra**, 424 F. 2d at 171.

[51] As the court of appeals noted in **Kahan, supra**, 424 F. 2d at 174, n. 14, **"In Asphatic Enterprises, Inc. v. Baldwin-Lima-Hamilton Corp.**, 39 F.R.D. 574, 576 (E.D. Pa., 1966), Judge John Lord stated that 'it is well established that the prayer for relief does not determine whether the plaintiff has stated a cause of action.'" **See also Truth Seeker Co. v. Durning**, 147 F. 2d 54, 56 (C.A. 2, 1945); **Dudley v. Zappa**, 24 F.R.D. 427 (S.D. N.Y., 1959); **Sarlie v. E. L. Bruce Co.**, 265 F. Supp. 371, 377 (S. D. N.Y., 1967). Indeed this Court in **Crane** recognized that one of plaintiff's remedies upon remand might include damages. 419 F. 2d at 803.

[52] **See e.g.**, the litigation: **Greenstein v. Paul, supra**, and **Greenstein v. Lebensfeld** (S.D. N.Y., March 3, 1970, now on appeal C.A. 2, No. 35384).

but flexibly to effectuate [their] remedial purposes." **Securities and Exchange Commission v. Capital Gains Research Bureau, Inc.**, 375 U.S. 180, 195; see **Tcherepnin v. Knight**, 389 U.S. 332, 336. Contrary to that principle, the purchaser-seller limitation adopts a restrictive test of standing which, as this Court has earlier recognized, is not "specifically required" by the statutory language.[53] Section 10(b) and Rule 10b-5 prohibit fraudulent conduct "in connection with the purchase or sale or any security." Nothing in this language limits standing to persons who have succeeded in becoming actual purchasers or sellers. These provisions, which define certain conduct as being unlawful, do not even purport to deal with the question of standing—a question which depends instead on the underlying Congressional purpose. In determining who has standing, i.e., whether the plaintiff is within the class of persons the statute was meant to protect, "a court's quest must be for what will best accomplish the purposes of the legislature." **Electronic Specialty Co. v. International Controls Corp.**, 409 F. 2d 937, 946 (C.A. 2, 1969).

The purpose of the Securities Exchange Act, as its title declares, was "[t]o provide for the regulation of securities exchanges and of over-the-counter markets . . . [and] to prevent inequitable and unfair practices on such exchanges and markets . . ." 48 Stat. 881. Congress intended, as stated in Section 2 of the Act, 15 U.S.C. 78b, "to provide for regulation and control" of "transactions in securities as commonly conducted upon securities exchanges and over-the-counter markets" and also of "practices and matters related thereto," and "to impose requirements necessary to make such regulation and control reasonably complete and effective," in order to insure the maintenance of fair and honest markets in such transactions." Consistent

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[53] Mutual Shares Corp. v. Genesco, Inc., 394 F.2d 540, 543 (C.A. 2, 1967).

with the Congressional expression of intent, the courts have emphasized that the Act was designed to "keep the channels of interstate commerce, the mail, and national security exchanges pure from fraudulent schemes, tricks, devices, and all forms of manipulation";[54] "eliminate deceptive and unfair practices in security trading";[55] and "protect the investing public," "promote free and open public securities markets" and "secure fair dealing in the securities markets."[56]

In light of the broadly remedial statutory purpose, persons who participate in the securities markets or in the securities trading processes are entitled to expect that the Act will provide them with an honest market place in which to do business. Participants who, as a result of fraudulent market activities, are prevented from engaging in securities transactions are no less entitled to the Act's protection than are those who are fraudulently induced to enter into such transactions. Indeed, it would be anomalous to hold that a violator who has successfully executed a fraudulent scheme that was designed to prevent the consummation of a purchase or sale (as alleged here) shall, because of his very success, be immune from liability to the aborted purchaser or seller whom he has intentionally injured. Yet that is precisely the effect of the holding of the court below.

An acceptance of the **Birnbaum** purchaser-seller doctrine we submit, is based on a misunderstanding of Rule 10b-5's purpose. Prior to the adoption of Rule 10b-5, although

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[54] **Hooper v. Mountain States Sec. Corp.**, 282 F. 2d 195, 202 (C.A. 5, 1960), **certiorari denied**, 365 U.S. 814 (1961).

[55] **Kahan v. Rosenstiel, supra**, 424 F. 2d 161.

[56] **Securities and Exchange Commission v. Texas Gulf Sulphur Co.**, 401 F. 2d 833, 858, 860 (C.A. 2, 1968), **certiorari denied**, 394 U.S. 976 (1969). See also **A. T. Brod & Co. v. Perlow**, 375 F. 2d 393, 397 (C.A. 2, 1967).

Section 17(a) of the Securities Act of 1933, 15 U.S.C. 77q(a), prohibited fraud which was committed in the "sale" of securities (i.e., fraud on purchasers), there was no general prohibition in the federal securities laws against fraud committed in the "purchase" of securities (i.e., fraud on sellers). One of the purposes of Rule 10b-5, as the Commission pointed out in its release accompanying the adoption of the rule, was to close that loophole by making it unlawful to commit fraud both in the purchase and in the sale of securities.[57] The court in **Birnbaum**, however, erroneously believed that the closing of that loophole was the "only" purpose of Rule 10b-5. 193 F. 2d at 463. On the basis of that premise, the court reached two conclusions: that Rule 10b-5 was "directed solely at that type of misrepresentation or fraudulent practice usually associated with the sale or purchase of securities" and that Rule 10b-5 "extended protection only to the defrauded purchaser or seller." 193 F. 2d at 464. Neither of those conclusions, it should be noted, was essential to the result reached in the case; the court could have based its denial of relief simply on the ground that there was no indication of any causal connection between the alleged violation of Rule 10b-5 and the plaintiffs' injury.[58]

In **Birnbaum** it was alleged that a corporation's controlling shareholder, after having rejected a favorable merger proposal by another company, sold his controlling block of stock to a group of customers of his own corporation at a premium that represented the power to use the corporation as a "captive" source of supply for the customer group. It was also alleged that certain misrepresentations had been made to the shareholders of the cor-

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[57] See Securities Exchange Act Release No. 3230 (May 21, 1942).

[58] **Crane Co. v. Westinghouse Air Brake Co.**, supra, 419 F. 2d at 797.

poration at the time of the rejected merger and after the later stock sale. The plaintiffs were shareholders of the corporation, seeking relief (presumably damages) on behalf of themselves and on behalf of the corporation. The alleged violation of Rule 10b-5 consisted of the making of the misrepresentations. The injury to the corporation and its shareholders, however, appears to have resulted not from the misrepresentations but from the sale of stock by the controlling shareholder.

That the statements made by the court in **Birnbaum** were not entirely correct was recognized in **A. T. Brod & Co. v. Perlow, supra**, 375 F. 2d at 396, where this Court expressly rejected the **Birnbaum** conclusion that Rule 10b-5 applies only to the type of fraud that is "usually associated with the sale or purchase of securities." Subsequently, in **Securities and Exchange Commission v. Texas Gulf Sulphur Co., supra**, this Court went further and rejected **Birnbaum's** underlying premise as to Rule 10b-5's purpose. The court discussed the Exchange Act's legislative history, which showed that Section 10(b) was intended to secure honest securities markets. 401 F. 2d at 858-859. The court also pointed out that, unlike the anti-fraud provision in Section 17(a) of the 1933 Act which applies to fraud committed "in" securities transactions, Section 10(b) applies more broadly to fraud committed "in connection with" such transactions. **Id.** at 860. Finally, the court concluded that the Commission, in adopting Rule 10b-5, intended "fully to implement the Congressional purpose and objectives underlying Section 10(b)" and accordingly that Rule 10b-5 was intended to accomplish more than just the limited purpose of closing the loophole referred to in the Commission release which accompanied the rule's adoption. **Ibid.** Thus, more recent decisions reaffirming the **Birnbaum** purchaser-seller doctrine have been based on ideas that this Court has rejected in other cases.

The error which the court made in **Birnbaum** resulted from a failure fully to appreciate the role occupied by Rule 10b-5 in the statutory scheme of investor protection. The court viewed Rule 10b-5 as dealing with the ordinary face-to-face situation in which A makes misrepresentations to B, who in reliance thereon enters into a securities transaction. Although even in 1952, when the court decided **Birnbaum**, Rule 10b-5 had been applied in other contexts, only in more recent years has the broad coverage of the rule come to be fully recognized. Insofar as private actions are concerned, today Rule 10b-5 may well be the single most important provision through which relief may be obtained under the federal securities laws; and both in private actions and in the Commission's own enforcement activities, Rule 10b-5 is one of the key provisions for maintaining the integrity of the securities markets. Of particular significance, for present purposes, is the rule's applicability to situations in which whole classes of persons are deceived - for example, the dissemination of fraudulent press releases affecting the entire market place,[59] the use of false representations to obtain shareholder consent to mergers,[60] and the making of fraudulent tender offers.[61] In certain of these situations it is possible, by deceiving a sufficiently large number of people, to injure a person who has not himself relied on the misrepresentations and has therefore not been deceived. In recognition of this factor, it has been held that the injured person in such a situation has standing to obtain damages under Rule 10b-5 notwithstanding his failure to satisfy

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[59] See **Securities and Exchange Commission v. Texas Gulf Sulphur Co., supra; Heit v. Weitzen**, 402 F. 2d 909 (C. A. 2, 1968), **certiorari denied**, 395 U. S. 903 (1969).

[60] See **Securities and Exchange Commission v. National Securities, Inc., supra.**

[61] **See Vine v. Beneficial Finance Co., supra; Crane Co. v. Westinghouse Air Brake Co., supra; Kahan v. Rosenstiel, supra.**

the traditional requirement that reliance be established in order to recover for fraud.[62] Thus, Rule 10b-5 does not, as the court in **Birnbaum** believed, deal only with a simple face to face transaction in which B relies upon A's misrepresentation. Rule 10b-5 is considerably broader in scope. And in view of this broad scope, the purchaser-seller limitation is an anachronism which conflicts with the present day need of investor protection.

Dissatisfied with the purchaser-seller limitation but unwilling to abandon it completely, the courts have tried to find ways of avoiding its impact. For example, this Circuit and the Third and Sixth Circuits have held that a person who is neither a purchaser nor a seller may maintain an action under Rule 10b-5 when the relief sought is an injunction against a continuing violation rather than damages.[63] At times, these efforts to avoid the effect of **Birnbaum** have resulted in somewhat strained reasoning and even in meaningless distinctions.[64] We submit that, instead of continuing this confused situation, the proper course of action is to reject the purchaser-seller limitation. The Supreme Court has stated that Rule 10b-5 is "an area where glib generalizations and unthinking abstractions are major occupational hazards."[65] The purchaser-seller limitation fits that description perfectly.

The Commission believes the proper view is that a claim under Section 10(b) and Rule 10b-5 is stated when an individual alleges that misrepresentations have influenced

[62] **Vine v. Beneficial Finance Co., supra; Crane Co. v. Westinghouse Air Brake Co., supra.**

[63] **Mutual Shares Corp. v. Genesco, Inc., supra; Kahan v. Rosenstiel, supra; Britt v. Cyril Bath Co.**, 417 F. 2d 433 (6 A. 6, 1969).

[64] See **Kahan v. Rosenstiel, supra; Crane Co. v. Westinghouse Air Brake Co., supra.**

[65] **Securities and Exchange Commission v. National Securities, Inc., supra,** 393 U.S. at 465.

his judgment to buy, sell or hold securities and he has suffered damages thereby. Several cases, in fact, have indicated that a claim under Rule 10b-5 may lie, even absent a purchase or sale of a security, provided that the individual to whom such misrepresentations were made alleges that he was thereby induced to retain securities which he might otherwise have sold. **Stockwell v. Reynolds & Co.**, 252 F. Supp. 215 (S.D.N.Y., 1965) held that a claim for damages under Rule 10b-5 would lie where misrepresentations induced customers of a broker-dealer not to sell their securities. In that case the court stated with respect to the "in connection with" language that "[t]he words have been construed more liberally in order to carry out the intent of the Act, which is designed **to protect investors** against fraud" (emphasis added) **id.** at 219. **Hanly v. Securities and Exchange Commission**, 415 F.2d 589 (C.A. 2, 1969) held that a broker-dealer who had said that certain stock was "worth holding" had violated the rule even though the individual to whom the representations were made merely continued to hold his stock and did not sell or purchase any shares. The view that misrepresentations or omissions of material fact which induce a shareholder to hold his securities are within the purview of Rule 10b-5 is also implicit in the definition of "materiality" adopted in **Securities and Exchange Commission v. Texas Gulf Sulphur Co., supra**, 401 F. 2d at 849; material facts include those "which may affect the desire of investors to buy, sell or hold the company's securities." (Emphasis added.) Cf. **Rekant v. Desser, supra**, 425 F.2d at 879.

It has been suggested that the motive for adhering to the purchaser-seller requirement has been that the requirement serves a useful function by limiting liability under the expansive language of Rule 10b-5.[66] To the extent

[66] **Mutual Shares Corp. v. Genesco, Inc., supra**, 384 F. 2d at 543; **Rekant v. Desser**, 425 F. 2d 872, 877 (C.A. 5, 1970).

that it serves this function, however, it does so in a purely fortuitous fashion that often produces unjust results. Thus, although on occasion the purchaser-seller requirement may operate to deny standing to a person who, for some reason, properly should be refused relief under Rule 10b-5, the requirement can just as frequently operate to deny standing to a person who should be afforded relief.

Since the purchaser-seller requirement thus operates in a fortuitous manner which often is unrelated to the statutory purpose, we believe that it should be rejected. There need be no fear, however, that Rule 10b-5 would then function without any limitations so as to impose unwarranted liability. There are various limitations—apart from the purchaser-seller requirement—which the courts can and do apply in a manner which is in accord with the statutory purpose. For example, a plaintiff cannot recover damages under Rule 10b-5 unless (1) the fraud related to a material matter,[67] (2) there was a casual connection between the alleged violation and the plaintiff's claimed loss,[68] and (3) a loss has, in fact, been sustained.[69] And the plaintiff must, of course, establish his damages with sufficient certainty to warrant recovery.[70] It should be noted that this case does not involve the question of whether damage liability for misrepresentations affecting large numbers of investors should be imposed in the absence of scienter. See **Heit v. Weitzen, supra**, 402 F. 2d at 913-914, 917; **Securities and Exchange Commission v. Texas Gulf Sulphur Co., supra**, 401 F. 2d at 866-868 (con-

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[67] **List v. Fashion Park, Inc.**, 340 F. 2d 457, 462, 464 (C.A. 2, 1965), certiorari denied, 382 U.S. 811.

[68] **Kahan v. Rosenstiel, supra**, at 172-73; **Mutual Shares Corp. v. Genesco, Inc., supra**, 384 F. 2d at 546-547.

[69] **Mutual Shares Corp. v. Genesco, Inc., supra**, 384 F. 2d at 546-547.

[70] Harper and James, **The Law of Torts** (1956), pp. 1304-1307.

curring opinion of Judge Friendly). The complaint specifically alleges that respondents knew of the falsity of their representations to the preferred shareholders and that they made those representations for the purpose of misleading the preferred shareholders.

CONCLUSION

For the foregoing reasons the complaint should not have been dismissed and the decision of the district court should be reversed.

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